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LOW-INCOME HOUSING TAX CREDITS AND THE ROLE OF TAX POLICY IN PRESERVING THE STOCK OF LOW-INCOME HOUSING

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

MARCH 2 AND 3, 1988

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LOW-INCOME HOUSING TAX CREDITS

WEDNESDAY, MARCH 2, 1988

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:11 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press release announcing the hearings follow:]

FOR IMMEDIATE RELEASE
WEDNESDAY, FEBRUARY 10, 1988

PRESS RELEASE #8
SUBCOMMITTEE ON SELECT
REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-9710

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A PUBLIC HEARING ON LOW-INCOME HOUSING TAX CREDITS AND THE ROLE OF TAX POLICY IN PRESERVING THE STOCK OF LOW-INCOME HOUSING.

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold public hearings on Wednesday, March 2 and Thursday, March 3, 1988, on the Low-Income Housing Tax Credit created by the Tax Reform Act of 1986 and the role of tax policy in preserving the stock of low-income housing. The hearings will begin at 10:00 a.m. each day in room 1100 Longworth House Office Building.

The Subcommittee will receive testimony from the Administration and other invited witnesses only. Others interested in these issues are requested to submit written statements for the hearing record.

In announcing these hearings, Mr. Rangel stated that, "The outlook for meeting the housing needs of low-income families in this country has gone from bleak to frightening. Section 8 and other direct spending programs have been cut. Tax reform eliminated some incentives for low-income housing but created a new credit. During the next few years, many low-income rental units may be withdrawn from the housing market as compliance periods under various assistance programs come to an end.

"The Subcommittee's first day of hearings will be devoted to the low-income credit. We want to know how well the provision is working, what can be done to improve its effectiveness and whether it should be a permanent part of this nation's housing policy. The second day will be devoted to the role of tax policy in preserving the stock of low- and moderate-income rental and cooperative housing. The Subcommittee will want to hear new ideas, and in this regard, witnesses will be expected to express their views on H.R. 3663, a bill to provide incentives to prevent the loss of low-income housing which Congressman Barney Frank and I introduced on November 19, 1987."

BACKGROUND

The Tax Reform Act of 1986 established a low-income housing tax credit (section 252 of the Act and section 42 of the Internal Revenue Code of 1986). The credit may be claimed by owners of residential rental property used for low-income housing. The credit is claimed annually, generally for a period of ten years. New construction and rehabilitation expenditures for low-income housing projects placed in service are eligible for a maximum 9-percent credit, paid annually for ten years. The acquisition cost of existing projects and the cost of newly constructed projects receiving other Federal subsidies placed in service in 1987 are eligible for a maximum 4-percent credit, also paid annually for ten years. For buildings placed in service after 1987, these credit percentages will be adjusted to maintain a present value of 70 percent and 30 percent for the two types of credits. Credit amounts are limited and are allocated by State agencies. The provision expires at the end of 1989.

H.R. 3663 would allow additional depreciation deductions to owners of low-income housing if they agree to maintain their property as low-income housing for an additional period of time. In addition, it would make certain modifications to the low-income housing credit and the rules regarding cooperative housing corporations.

WRITTEN STATEMENTS:

Persons submitting written statements for the printed record of the hearings should submit at least six (6) copies of their statement by the close of business, Thursday, March 17, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1111 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

* * * * *

Chairman **Rangel**. I apologize to the distinguished Senators, and the Subcommittee on Select Revenue Measures will come to order.

This morning, we intend to review the recently passed low-income housing credit as some meager substitute for the lack of a coherent Federal housing policy.

In the urgency to get some type of tax reform, passive losses as a vehicle to create low-income houses was eliminated, and we had to hastily put together some type of substitute which we had no idea whether it could work, but we are hopeful, and the purpose of this hearing is to find out whether or not this type of credit is good housing policy and whether it is good tax policy.

We do hope that we can hear from HUD, who has dramatically reduced their subsidies to low- and-moderate housing from $26 billion in 1981 to $7.4 billion in 1987. The section 8 program, itself, has been reduced since 1981 by over 97 percent.

So, we cannot believe that HUD would be the place to go for incentives, and that is why Treasury is going to be the official agency for what we do in this area.

Nevertheless, we hope that we can get some encouraging input from the Housing and Urban Development Department.

And so, we are glad that the Senators are here. We have lost a lot of ground, since it took some time for Treasury to get the regulations, for the States to understand them, for developers to want to be involved with them, and the fact that we are looking at a different group of investors for low-income housing.

Changes have to be made with technical corrections. Perhaps other subsidies have to be thought of, and packages have to be put together, but we do hope that with the ever-increasing number of homeless people, and those seeking shelter, that the Federal Government, even through the Tax Code, might be able to lend a helping hand.

So, it is my pleasure to introduce to those people that have no television sets, the Honorable Alfonse D'Amato, who has been doing a great job, not only for the people in the State of New York, but for our great Nation, and your prepared statement will be entered into the record, and we hope that you would proceed to share your thoughts with us, as you feel most comfortable.

STATEMENT OF HON. ALFONSE M. D'AMATO, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator **D'Amato**. Thank you very much, Mr. Chairman, and I am privileged to be with you today in the company of my distinguished colleague, the senior Senator from Maine, Senator Mitchell. Judge Mitchell, I like to call him, because he still carries that eloquence, and the legal brilliance which distinguishes him from his peers in the Senate. I am often awed by the manner of his presentation, and the precision of his remarks.

Let me attempt to summarize, Mr. Chairman, because we do have time constraints. Allow me simply to say that the problem of housing for low-income people is one which is being visited among many working families and people of middle income.

And the day is rapidly approaching when these middle-income families may indeed join the ranks of the homeless.

It is estimated that 1.8 million units of existing subsidized housing may disappear by the year 2000. I say the year 2000. That is 12 years from now. It is right around the corner.

Some 1.8 million units will disappear. And this will occur for a number of reasons, including mortgage prepayments. Mr. Chairman, that is not just on the Federal level. As it relates to our home problem in New York, the Mitchell-Lama units, whose contracts are expiring, will diminish the State's middle-income housing stock. This includes 84,000 units in New York City.

Take a look at the city of Albany, a city of 100,000 people, there are 1,100 units that may be turned into condominiums. These units will go condo and will be well beyond the ability of middle-income working families to afford.

There are 3,100 Mitchell-Lama units in Erie County and 8,100 in Monroe County. Monroe County is a county of about 800,000 people, and here, we are talking about 8,100 units.

We are talking about significant numbers of middle-income people who are living in these units. This represents a crisis in the making. And it is taking place now.

According to Mayor Koch's commission, on the year 2000, 447,000 units have to be upgraded, and 231,000 units built to meet current demands. This is simply not being done.

The fact of the matter is, as a result of tax reform that was passed in 1986, we are not building any housing today for low-income and middle-income families.

A report on affordable housing, that I am releasing today, Mr. Chairman, says that from 1980 to 1985, the various housing agencies in New York built over 25,000 low- and moderate-income units. This report outlines that not one traditional bond-financed housing unit has been built since the passage of the Tax Reform Act, despite the obvious need. Not one. And that is in our State of New York, but is true throughout the country.

The combination of unrealistic income limits, and annual recertification rules makes it almost impossible to build low- and moderate-income housing in New York.

The report that I am releasing today recommends including the cost of construction in the income-limit calculations. Also, that existing exceptions for New York from the recertification provisions be broadened. The report addresses tax-exempt bonds, but the exact same problems exist for the low-income housing tax credit. Any changes in the bond provisions should also be made to the housing tax credit.

Mr. Chairman, I am going to ask that that report be made a part of the record.

Chairman **Rangel**. Without objection.

Senator **D'Amato**. To forestall prepayments, Mr. Chairman, your bill, H.R. 3663, proposes that the housing tax credit be offered to owners of existing low-income housing units, is a necessity. Also, your bill would restore the original depreciation schedules to already depreciated housing stock, if the owner agrees to maintain the subsidized units.

Let me conclude by saying this: Mr. Chairman, unless we take the steps you propose, then the calculations of losing 1.8 million units will will become a reality.

You are right to propose tax incentives to the owners of Mitchell-Lama units and similar Federal tax subsidy programs. I doubt very much we should pass a bill that imposes a moratorium on Mitchell-Lama and section 8 conversions. I doubt whether the Congress would pass that, and that we are just going to take away an owner's property rights.

We need the kind of imaginative, creative legislation that you propose, to give to the owners of subsidized properties an opportunity to earn a fair return. This will keep those housing units in existence, so that low- and moderate-income families are not thrown out on the street.

We have no program to deal with this issue. Your bill may not solve all of the problems, but I think it can play a crucial role, and make a significant difference in this battle.

So I commend you, Mr. Chairman, for your initiatives, and I look forward, certainly, to working with you and Senator Mitchell to make this a reality.

[The statement of Senator D'Amato follows:]

STATEMENT BY SENATOR D'AMATO
WAYS AND MEANS COMMITTEE
MARCH 2, 1988

MR. CHAIRMAN, THE HOMELESS ARE NO LONGER JUST THE INDIGENT. TODAY, LOW-INCOME WORKING PEOPLE OFTEN CAN NOT FIND HOUSING. MANY LIVE ON THE STREETS. WHETHER ITS NEW YORK CITY, ROCHESTER, OR SYRACUSE--EAST COAST OR WEST COAST-- WE ARE IN THE MIDST OF A NATIONAL HOUSING CRISIS.

THE DAY IS RAPIDLY APPROACHING WHEN MIDDLE-INCOME FAMILIES WILL JOIN THE RANKS OF THE HOMELESS. I HOPE MEANINGFUL HOUSING INITIATIVES ARE NOT DELAYED SO LONG THAT MIDDLE-INCOME FAMILIES ARE FORCED OUT ON THE STREETS.

MR. CHAIRMAN, THE HOUSING CRISIS IS ONE OF THE BEST KEPT SECRETS IN WASHINGTON. YOU AND I HAVE SPENT COUNTLESS HOURS TRYING TO MAKE OUR COLLEAGUES AWARE OF THE MAGNITUDE OF THIS CRISIS.

THE ULTIMATE SOLUTION IS MASSIVE REFORM OF BOTH TAX POLICY AND HUD ADMINISTERED PROGRAMS. DURING THE 1980s, GOVERNMENT SUPPORT OF HOUSING HAS MOVED IN REVERSE. TAX REFORM ENDED OR EFFECTIVELY KILLED MOST HOUSING INCENTIVES. THE FEDERAL BUDGET FOR HOUSING PROGRAMS HAS BEEN CUT FROM $30 BILLION IN 1980 TO $7.1 BILLION IN 1987.

MR. CHAIRMAN, ALLOW ME TO QUANTIFY THE EXTENT OF THE HOUSING CRISIS. IT IS ESTIMATED THAT 1.8 MILLION UNITS OF EXISTING SUBSIDIZED HOUSING MAY DISAPPEAR BY THE YEAR 2000. THIS WILL OCCUR FOR A NUMBER OF REASONS INCLUDING MORTGAGE PREPAYMENTS, DETERIORATION AND EXPIRING SECTION 8 CONTRACTS.

IN NEW YORK STATE, THE HOUSING SHORTAGE IS ALREADY OF CRISIS PROPORTIONS. THE PROBLEM IS BOTH PRESERVATION OF THE EXISTING STOCK AND PRODUCION OF NEW UNITS. FOR INSTANCE,

** MITCHELL-LAMA UNITS WHOSE CONTRACTS ARE EXPIRING MAY GREATLY DIMINISH THE STATE'S MIDDLE-INCOME HOUSING STOCK. THIS INCLUDES 84,259 UNITS IN NEW YORK CITY, 1109 UNITS IN ALBANY, 3180 UNITS IN ERIE COUNTY, 8172 UNITS IN MONROE COUNTY, AND 3157 UNITS IN ONONDAGA COUNTY.

** ACCORDING TO THE MAYOR'S COMMISSION ON THE YEAR 2000, OVER 447,100 UNITS MUST BE UPGRADED AND 231,000 UNITS BUILT TO MEET CURRENT DEMAND. BY THE YEAR 2000 THE HOUSING SHORTFALL IN NEW YORK CITY WILL RISE BY ANOTHER 372,000 UNITS.

** THE NEW YORK STATE DIVISION OF HOUSING AND COMMUNITY RENEWAL HAS ESTIMATED THAT OVER 1 MILLION UNITS ARE NEEDED TO FILL THE HOUSING GAP.

IN THE PAST, THE NEW YORK CITY HOUSING DEVELOPMENT CORPORATION AND THE STATE'S HOUSING FINANCE AGENCY HAVE BEEN RESPONSIBLE FOR BUILDING LOW- AND MODERATE-INCOME HOUSING. THERE WORK HAS BEEN FINANCED WITH TAX-EXEMPT BONDS.

A REPORT ON AFFORDABLE HOUSING THAT I AM RELEASING TODAY FOUND THAT FROM 1980 THROUGH 1985, THESE AGENCIES BUILT OVER 25,000 LOW- AND MODERATE-INCOME UNITS. THE REPORT OUTLINES THAT NOT ONE TRADITIONAL BOND-FINANCED HOUSING UNIT HAS BEEN BUILT SINCE THE PASSAGE OF TAX REFORM. DESPITE THE OBVIOUS NEED, THE AGENCIES NEW YORK RELIES ON TO BUILD AFFORDABLE HOUSING CAN NOT DO THEIR JOBS.

WHY? TAX REFORM REQUIRED BOND-FINANCED BUILDINGS TO HAVE 20% OF THEIR UNITS OCCUPIED BY PEOPLE AT 50% OF MEDIAN INCOME. IN A HIGH COST AREA SUCH AS NEW YORK, LOW-INCOME PEOPLE CANNOT AFFORD TO LIVE IN THESE BUILDINGS. IF THE OWNER INCREASES THE SUBSIDIES TO THESE TENANTS, THE ECONOMICS OF THE PROJECT IS DESTROYED.

ANOTHER PROBLEM IS THE RECERTIFICATION RULES FOR BOND-FINANCED BUILDINGS. THESE RULES REQUIRE OWNERS TO ANNUALLY CERTIFIY THAT THE LOW-INCOME TENANTS ARE STILL LOW-INCOME. IF A UNIT IS NO LONGER OCCUPIED BY SUCH A TENANT, THEN THE NEXT AVAILABLE UNIT MUST BE GIVEN TO A LOW-INCOME FAMILY. IN A RENT CONTROL AREA, THE RECERTIFICATION PROVISIONS MAY RESULT IN AN ENTIRE BUILDING BEING OCCUPIED TENANTS PAYING BELOW MARKET RENTS.

THE COMBINATION OF UNREALISTIC INCOME LIMITS AND ANNUAL RECERTIFICATION MAKES IT ALMOST IMPOSSIBLE TO BUILD LOW- AND MODERATE-INCOME HOUSING IN NEW YORK. THE REPORT I AM RELEASING TODAY RECOMMENDS INCLUDING THE COST OF CONSTRUCTION IN THE INCOME LIMIT CALCULATION. ALSO, THAT THE EXISTING EXCEPTION FOR NEW YORK FROM THE RECERTIFICATION PROVISIONS BE BROADENED.

MY REPORT ONLY ADDRESSES TAX-EXEMPT BONDS. BUT THE EXACT SAME PROBLEMS EXIST FOR THE LOW-INCOME HOUSING TAX CREDIT. ANY CHANGES IN THE BOND PROVISIONS SHOULD ALSO BE MADE TO THE HOUSING TAX CREDIT. I ASK THAT MY REPORT BE MADE PART OF THE RECORD.

IN TERMS OF PRESERVATION, THE MITCHEL-LAMA CRISIS LOOMS LARGER AND LARGER EACH DAY. MR. CHAIRMAN, YOUR PROPOSALS TO EXTEND TAX INCENTIVES TO OWNERS OF EXISTING LOW- AND MODERATE-INCOME UNITS IS THE APPROACH CONGRESS MUST PURSUE.

YOUR BILL, HR 3663, PROPOSES THAT THE HOUSING TAX CREDIT SHOULD BE OFFERED TO OWNERS OF EXISTING LOW-INCOME HOUSING UNITS. ALSO, YOUR BILL WOULD RESTORE THE ORIGINAL DEPRECIATION SCHEDULE TO ALREADY DEPRECIATED HOUSING STOCK IF THE OWNER AGRESS TO MAINTAIN THE SUBSIDIZED UNITS. I FULLY SUPPORT THESE PROPOSALS.

IN THE RECENTLY PASSED HOUSING BILL. SENATOR CRANSTON AND I WERE ABLE TO INCLUDE ADDITIONAL FINANCIAL INCENTIVES TO OWNERS OF EXISTING SUBSIDIZED HOUSING UNITS IF THEY DO NOT PREPAY. SAFEGUARDS WERE ALSO INCLUDED TO INSURE THAT TENANTS' RIGHTS ARE PROTECTED. YOUR BILL IN TANDEM WITH THE HOUSING BILL WOULD GO A LONG WAY TOWARD SOLVING THE PRESERVATION PROBLEM.

WHAT IS THE ULTIMATE ANSWER TO THE HOUSING CRISIS? THE SOLUTION IS NOT SIMPLE. BUT, AT A MINIMUM, MASSIVE REFORM OF BOTH TAX POLICY AND HUD ADMINISTERED PROGRAMS MUST OCCUR.

REPORT ON
THE STATE OF NEW YORK'S
TAX-EXEMPT BOND-FINANCED HOUSING PROGRAMS

PREPARED BY:

SENATOR ALFONSE D'AMATO'S
ADVISORY PANEL ON AFFORDABLE HOUSING

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A. EXECUTIVE SUMMARY

Rising land and construction costs, combined with the drastic curtailment of most indirect Federal income tax incentives for the development of low- and moderate-income housing have helped to create a housing crisis of dramatic proportions in New York State. The increasing shortage of affordable housing has become a concern of all families who seek rental housing and has made the dream of homeownership all but impossible for low- and moderate-income New Yorkers.

All major studies indicate that the housing crisis in New York State is likely to get worse before it gets better despite the direct efforts of the State and New York City to replace some of the Federal funding lost in the 1980's. At the beginning of the decade, New York State's housing shortage was estimated to be over 1 million units. This gap continues. By the year 2000, the City alone anticipates a gap of 372,000 units. One need only read the newspapers to know that virtually every major corporation which has decided to relocate has cited the lack of affordable housing as a significant contributing factor in its decision to move from the State.

Over the past generation, the State and City of New York have pioneered many innovative housing finance programs in order to provide affordable accommodations for their citizens. Through the use of direct appropriations, real estate tax abatements, land writedowns and tax-exempt financing, the State and City have successfully financed hundreds of thousands of low- and moderate-income housing units, both rental and homeownership.

However, the Tax Reform Act of 1986 (the "Tax Act") placed such severe limitations on the use of tax-exempt financing, that it is no longer a viable and useful tool in the production of low- and moderate-income housing. In fact, the multi-family housing agencies are anticipated to finance few, if any, traditional new low-income multi-family rental units whatsoever this year, and the single-family homeownership program will lose 40% of its previous market. Ironically, unworkable income limitations imposed by the Tax Act render the homeownership program least effective in precisely those areas of the State where housing affordability problems are most severe.

The pipeline of new tax-exempt bond financed single and multi-family housing projects is running dry. The purpose of this report is to suggest certain "revenue neutral" changes to the Tax Act which could have a positive impact in once again making tax-exempt financing a useful tool in the State's and City's efforts to provide affordable rental and homeownership opportunities. The suggested changes are:

1. Multi-Family Rental

a) Income Limits in High Cost Areas

- o Establish a formula to enable high cost/low-income areas to adjust the median income limits established in the Tax Act. In high cost/low-income areas, the level of rents which tenants at the maximum income levels, 50% or 60% of area median income, can afford to pay is simply insufficient to cover all the costs of operating rental housing. In many areas, such as New York City, high construction costs are often compounded by extremely high operating expenditures. In such instances, affordable rents for

tenants at 50% of median income do not even cover maintenance and operating expenses and there is no cash flow to support any debt service.

b) Recertification of Low-Income Tenants

- Amend the "deep rent skewing" rules to provide for use of the less onerous compliance procedures for projects in which the average market rents are two times the "low-income" rents (instead of three times).
- Permit state and local contributions to be counted in calculating the rents which would otherwise have to be charged to the market rate tenants without such government assistance in determining whether projects meet the "2 to 1" market rate to low-income rent test (described above).

2. Single-Family Owner Occupied

a) Mortgage Revenue Bond Sunset

Eliminate the December 31, 1988 "sunset" provision for Mortgage Revenue Bonds (MRB): current law would "sunset" or terminate the MRB program at the end of 1988. Congress should act to make the MRB program permanent, and at the same time extend the ability to current refund MRB's.

b) Income Limits in High Cost Areas

Establish an affordability-based income limit for those areas where high housing costs and low median incomes now make the MRB program unworkable due to the inflexible income limit standard enacted in the Tax Act.

c) Financing of Two-Family Homes

Permit MRB's to be utilized to finance new two-family homes. Currently, MRB proceeds cannot be loaned for purposes of constructing new two-family units. MRB mortgages can be used to finance existing two-family homes. Aside from the incongruity of this policy, eliminating this restriction would encourage the development of this cost-efficient type of home.

3. General Bond Restrictions

Eliminate the provision requiring housing finance agencies to rebate to the Federal government earnings from investments made with funds contributed by state and local governments or by private sources.

Each of these recommendations will contribute toward making tax-exempt financing for housing more workable in all areas of the country. The recommendations are made,

however, in keeping with the Congressional spirit of revenue neutrality (i.e., the adoption of these proposals will not result in an increase in foregone Federal revenue). We believe that additional modifications to the tax-exempt housing bond programs are necessary in order to fully restore them as useful tools of the state and local governments in providing affordable housing. Over the course of the next year, this Panel is prepared to work with Senator D'Amato and the full Congress as they attempt to develop a comprehensive approach to alleviate our nation's growing housing crisis in the 1990's. Meaningful changes to the tax-exempt bond housing programs must be part of the nation's housing agenda for the next decade.

B. NEW YORK STATE'S HOUSING NEEDS

The diversity of New York State makes it, in many ways, a microcosm of the nation. This fact is reflected in the State's housing needs and the variables which control them.

In 1986, when the building industry began to gird itself for tax reform, housing starts began to decline after climbing inordinately high in 1985 (23,368 permits). New York City's level of housing production fell to 10,552. Even when compared with 1984 permits, which reflect more ordinary numbers, there is a drop of over a thousand starts.[1] This drop-off is particularly disconcerting in view of a 1984 report issued by the State's Division of Housing and Community Renewal which cited a 1 million unit housing gap in New York State, based on a 1979 survey.[2]

This housing gap was confirmed earlier this year by New York City's Commission on the year 2000 in its housing study which concluded:

> Not enough units exist to decently house the City's current population. An estimated 447,100 units must be upgraded and 231,000 created to fill the housing shortage today. After considering a number of factors, our conservative assessment of the housing gap between now and the year 2000 places the shortfall of new units at 372,000. New housing production must increase by 26,600 units per year to close the gap by the beginning of the next century.[3]

It is important to note that these estimates of housing need do not differentiate between homeownership and rental units or affordability levels of rental stock. The National Association of Homebuilders, in its recent "Housing Backgrounder" states:

> For the first time since the 1930's, the nation's homeownership rate has turned significantly downward . . . after climbing steadily from a rate of 43.6% in 1940 . . . to a peak rate of 65.8% in the third quarter of 1980, the homeownership rate started declining. It reached 63.9% in 1985.[4]

According to the same study, this decline has been inordinately apparent among young households. It claims that while homeownership rates among those fifty and older have remained relatively stable, those under thirty-five have registered a sharp decline.[5] This decline in homeownership is particularly distressing in the northeast, the region that traditionally has the lowest homeownership rates.

These figures illustrate the need to encourage both homeownership and rental housing programs across the nation and in New York State. Unfortunately, the Tax Act moved in the opposite direction by eliminating or severely restricting most housing tax incentives. Although state and local governments have tried to fill the void, their success has been limited by both the Tax Act and budgetary constraints.

C. THE PROVISIONS OF THE TAX REFORM ACT OF 1986

1. General/Housing Real Estate

Housing was perhaps the industry most severely impacted by the Tax Act. Congressional efforts to remove tax incentives from investment and business planning lead to far reaching changes in the Internal Revenue Code's (IRC) treatment of real estate, in general, and low-income housing, in particular. The Tax Act:

- lengthened the depreciation period from as short as five years for expenditures incurred to rehabilitate low-income housing, to 27.5 years and required the use of straight line depreciation instead of the more favorable accelerated method.

- required that construction period expenses, such as construction loan interest and real estate taxes, be capitalized and depreciated over 27.5 years, rather than "expensed" in the years in which they are incurred.

Combined with the overall reduction in tax rates, the effects of the Tax Act was to drastically reduce the value of the losses which were critical to the production of low-income housing as illustrated in the following example:

- An individual acquires an abandoned house from a municipality for $1 and spends $20,000 to rehabilitate it. Following the rehabilitation, the unit is rented to a low-income household. Under the previous IRC, the depreciation losses in the first year of operation of this low-income unit were potentially worth up to $2,000 assuming the owner 1) utilized the five year depreciation schedule available then, and 2) was in the 50% marginal tax bracket. Under the new IRC, the depreciation losses were only worth $204 assuming a 27.5 year depreciation schedule and a 28% marginal tax rate.

The potential tax savings were crucial to inducing investment in low-income housing, as the rents which low-income tenants can pay are usually insufficient to cover all the costs of operation, including debt service. This is particularly true where the cost of construction and operating expenses are high and the incomes of eligible low-income families are low.

The Tax Act not only drastically reduced the value of depreciation losses, it also eliminated the ability of most investors to actually take advantage of these minimal tax benefits. The enactment of the so-called "passive loss" provisions placed severe restrictions on the ability of most potential investors to deduct passive losses generated by ownership in rental housing.

Such passive losses may only be utilized to offset passive income. Tax losses generated by the ownership of low-income rental housing may no longer be utilized to offset all forms of active and investment or portfolio income. As low-income rental housing, by its very nature, does not generate positive cash flows, even the drastically reduced potential tax benefits generated by ownership in such housing have been rendered virtually useless. This change in the IRC has all but dried-up the pool of private equity capital available to construct low-income rental housing.

Although Congress attempted to generate investor interest in low-income housing through the creation of a new low-income housing tax credit, the program will require the enactment of substantial amendments to its provisions to make it workable. However, even if the tax credit is refined and accepted by the development and the investor community, its value still will not equal that of the other incentives eliminated by the Tax Act.

2. Tax-Exempt Bond Restrictions

In addition to severely reducing the value of tax benefits associated with the ownership of low-income rental housing, the Tax Act has virtually eliminated the ability of tax-exempt bonds to finance traditional multi-family rental housing. It has also virtually eliminated the ability of tax-exempt bonds to finance single-family housing in the high cost areas of the State, such as Long Island and Westchester. It is the purpose of this report to focus on those provisions of the Tax Act which, if amended as proposed, could help to partially restore tax-exempt financing as a viable tool for the State and City in their efforts to provide affordable housing.

The Tax Act imposed these new restrictions on all tax-exempt Private Purpose Bonds, including multi-family and single-family bonds.

- Interest on tax-exempt private purpose bonds is considered to be a preference item for persons calculating their Alternative Minimum Tax liability. As a result of the interest on these tax-exempt bonds potentially being taxable, state and local issuers must pay bond purchasers a higher interest rate, making it more difficult to provide affordable multi-family or single-family mortgages.

- Private purpose bonds are subject to a very restrictive volume cap. The cap will decline from $150 per capita in 1985 to $50 per capita in 1988, a 67% reduction. In addition, both multi-family and single-family bonds, which were not subject to the $150 cap, are subject to the reduced $50 cap. In 1988, the total private purpose bond cap for the State of New York will equal only $890 million. In 1985, the housing agencies represented herein issued $1.6 billion.

- The Tax Act requires state and local governments to rebate to the Federal government all excess earnings on investments of monies pledged to tax-exempt bondholders. This amounts to a 100% tax on states and localities. This rebate is required on earnings of all monies invested, even non-bond proceeds.

a. Multi-Family Programs

1. The Tax Act requires that at least 20% of the units in a tax-exempt bond financed project must be rented to households at 50% of area median income or 40% (25% in New York City) must be rented to households at 60% of median. All calculations must be made in accordance with adjustments for family size. This requirement is substantially more restrictive than the previous income limits (i.e., 20% of the units at 80% of area median).

2. Tenants' incomes must be recertified annually. Tenants whose incomes exceed 140% of the maximum limit (i.e., 50% or 60% of area median income) may no longer be counted toward meeting the minimum low-income setaside requirement (i.e., 20% or 40% of the units, respectively). In the event the project fails to meet the minimum setaside requirement, the owner must rent the next available market rate unit of comparable or smaller size to a qualified low-income tenant. As such market rate units are likely to rent for considerably more than the low-income units, the project owner faces a significant loss of rental income if it becomes necessary to convert market rate units to low-income ones over the life of the 15 year compliance period. Under previous law, there was no recertification requirement.

   In recognition of the possible tremendous loss of income to project owners resulting from the recertification requirement, the Congress did carve out a small exception for projects in which there was a vast disparity between market rate and low-income rents. For such deep-rent skewed projects, as they are referred to in the Tax Act, a less onerous penalty is provided if such a project fails to meet the minimum setaside. For a deep-rent skewed project in which the average market rents are at least three times as great as the average low-income rents, in the event that the project no longer meets the minimum setaside, the owner is required to rent the next available low-income unit to a low-income household at 40% of median income. For such projects, the potential loss of income is limited to the low-income component of the project. The possibility of an 80% market rate/20% low income project becoming a 50/50 project without sufficient income to meet its expenses is virtually eliminated for deep-rent skewed projects. However, because the "3 to 1" rent skewing rule is extremely difficult to meet, very few, if any, projects can qualify as deep-rent skewed.

3. The minimum low-income period was lengthened by the Tax Act to 15 years from 10 years.

b. Single-Family Programs

1. **The Tax Act establishes income limits for borrowers of 115% and 140% of the greater of area or statewide median income in non-target and target areas, respectively. Previously, the tax code did not require income limits.**
2. **Purchase price limits have been reduced to 90% and 110% of local average housing costs in non-target and target areas, respectively.**
3. **MRB's have been placed within the statewide volume cap for private purpose tax-exempt bonds.**

Although the purchase price and volume restrictions reduce State of New York Mortgage Agency's (SONYMA) activity, it is the income limit restrictions which ironically and inequitably render the program least effective in areas with the greatest affordability problems. The income limit formulation in the Tax Act assumes that there is a generally predictable relationship between the median income and local housing costs. However, this relationship does not necessarily exist. For example, the New York City metropolitan area has an income limit $6,000 lower than metropolitan Chicago. The average home price, on the other hand, is nearly $50,000 higher in New York City than in Chicago. There is no flexibility in the income limits to accommodate this type of variation. The Tax Act will, therefore, tremendously diminish the State's homeownership program in high cost areas. But for the limited ability to recycle money from pre-existing bond issues, which do not carry the new limitations, the effects would be felt today. Using a combination of recycled proceeds plus new funds, SONYMA has been able to meet some of its demand this year, providing over 4,000 mortgages to date. If all of these mortgages were subject to the new guidelines, however, a majority of the loans provided in the high cost downstate areas would have been denied.

D. THE EFFECTS OF THE TAX REFORM ACT ON HOUSING PRODUCTION IN NEW YORK STATE

The State and City of New York have pioneered the use of tax-exempt financing to create affordable housing over the past 35 years. The State and the City began financing housing through general obligation bonds in the 1950's. The New York State Housing Finance Agency (HFA) was created in 1960 as a public benefit corporation to finance multi-family housing. The New York City Housing Development Corporation (HDC) was created in 1971 to finance multi-family housing in the City. SONYMA was created in 1970 to finance single-family housing through the issuance of tax-exempt debt.

Between 1955 and 1980, tax-exempt financing provided about 190,000 units of housing for low- and moderate-income New Yorkers. Over 100,000 of these units were financed by either HFA, HDC or SONYMA.

In 1980, Congress began imposing constraints on the ability of state and local governments to utilize tax-exempt bonds to finance affordable housing, a process which culminated in passage of the Tax Act. However, despite the limitations imposed on HFA, HDC and SONYMA from 1980 through 1985, these agencies were able to continue to meet their mandate to provide affordable mortgage capital. HFA and HDC financed over 25,000 units of low- and moderate-income rental housing during this period, many of which relied on other direct subsidies from local, state and Federal sources and far exceeded the minimum setaside requirements in the IRC. As Federal subsidies evaporated, the HFA and HDC financed projects met or exceeded the minimum requirements of the IRC by skewing rents (i.e., charging higher market rents to support the low-income component) to the extent possible and by using state and local subsidies.

Since the passage of the Tax Act not one traditional bond-financed rental housing project subject to the new income limits has been financed by either HFA or HDC. Only projects granted immunity from the new guidelines by transition rules or those able to avoid the new rules through use of Section 501(c)(3) issued bonds have been financed.

SONYMA-administered homeownership programs were also successful during this period. From 1980 to 1985, 38,500 New Yorkers used the program to purchase their homes. Clearly, these homebuyers were within income levels deemed worthy of the program's use. From 1983 to 1985, MRB loans from SONYMA were used by New Yorkers who earned an average of $34,000 per year to purchase homes that had an average cost of $58,300.

The Tax Act excludes 40% of SONYMA's statewide market including 70% of the New York City metropolitan area market, 40% of the Long Island market, and 25% of the upstate market. SONYMA's ability to provide reasonable assistance to first time homebuyers in the high cost downstate areas is only possible due to the limited and temporary availability of recycled funds not subject to the limitations imposed by the Tax Act.

In summation, the provisions of the Tax Act have rendered what was once New York State's most successful low- and moderate-income financing program virtually useless. A recent task force of leading businessmen, public officials and academics called upon to examine the problems and solutions confronting the City of New York as it prepares for the twenty-first century was led to conclude "by imposing severe limits on tax-exempt borrowing for housing, the Tax Act has made it impossible to finance the elimination of the housing gap with revenue bonds."[6]

E. RECOMMENDATIONS FOR CHANGE

In making its recommendations for changes in the Tax Act, the Panel is cognizant of the budgetary constraints within which the Congress must work. All the proposals put forward by the Panel are, therefore, "revenue neutral." The Panel seeks to ask relief only from the across-the-board inflexible user eligibility requirements placed upon the multi-family and single-family tax-exempt bond programs by the Tax Act. Neither the tenant income limits for the multi-family program, nor the borrower income limits for the single-family program are sensitive to local variations in construction and land costs, operating expenses and their relation to area median income. As such, the programs are now unworkable in many areas of the nation, and most regions of New York State. The Panel is also aware of Congressional intent to target these programs to deserving families. However, we believe that it is possible to provide state

and local government with flexibility to design workable programs while still ensuring that the tax-exempt bond programs are adequately targeted.

1. Multi-Family Program Changes

a. Income Limits

The Panel recommends that targeting for tax-exempt financed multi-family housing programs be adjusted by a formula which compares local costs of multi-family housing construction, land and area median incomes, with similar national costs and incomes. The current income limits (i.e., 50% or 60% of median) would be used as a base. In areas where the cost of construction exceeded the national average and/or where the median income fell below the nationwide median, the income limits could be adjusted upward. Areas where construction costs were lower than the national average or median income was higher would be held harmless from a reduction in the new income limits imposed by the Tax Act.

The formula which the Panel recommends be adopted would compare area construction costs and median incomes to such national standards. The numerator of the formula would compare area costs of multi-family housing construction with nationwide costs. The denominator would compare area median incomes with the national median income. The formula is expressed below:

$$\frac{\text{area cost of multi-family construction}}{\text{national cost of multi-family construction}} \div \frac{\text{area median income}}{\text{national median income}}$$

The Panel recognizes that construction costs and median incomes are not necessarily the only factors which should be utilized in adjusting the income limits imposed on state and local governments by the Tax Act. Such factors as land costs and operating expenses should, ideally, also be considered. However, the adoption of an index based on all these factors might be too problematical to produce. Therefore, the Panel believes that a construction cost/median income index would be the most practical to devise and adopt and that it would help to alleviate many of the problems created by the inflexible income limits imposed by the Tax Act. In high cost/low median income areas, it is simply not feasible for tenants at 50% of median income or below to pay sufficient rent to enable project owners to meet their expenses, including debt service. This is particularly true in high cost areas with low median incomes. Contrast New York City, where 50% of median income is $14,750 and it may cost in excess of $100,000 to construct a unit, with suburban Washington, where 50% of median income exceeds $20,000 and the cost of constructing a garden apartment may be only half as much as in New York City.

The concept of a construction cost index that recognizes variations in local construction costs has already been proposed for hospital capital costs. The Department of Health and Human Services (HHS) engaged Dodge Data Resources, Inc. to develop the construction cost index.

The database was developed by Dodge under which a national construction cost mean was set as 1.000. Local variations were taken into account by accumulating a fifteen year average cost comparison of 365 different geographic areas, and dividing that number by national costs for the same period. That construction index ranges from a low of .728 to a high of 1.717.

This Panel also engaged Dodge to prepare a cost index for multi-family housing, comparing New York City to the nationwide average. The Dodge index indicates that the cost of constructing multi-family housing in New York City is 1.54 times the average nationwide cost. Thus, 1.54 would be the numerator in the proposed formula. As the New York City median is the same as the national median income, the denominator of the proposed formula would be 1.00. Using this formula, the 50% of median income standard would be eligible to be increased to 77% of median (50% x 1.54 ÷ 1). The Panel would imagine that New York City's ratio would be among the highest in the nation. Therefore, it is likely that most other high cost low median income localities will fall between 50% and 77% of median income.

b. Annual Recertification

The Panel recommends that two changes be made to the deep-rent skewing rules to permit them to be more workable. First, it is proposed that the "3 to 1" market rate to low-income rent test be reduced to "2 to 1." Very few, if any, projects can meet the "3 to 1" test. For projects which fall between the current and proposed rent-skewing requirements, the potential loss of income which would be required through the conversion of market rate apartments to low-income units would be so great as to make it impossible for owners to meet their financial obligations over time. Reducing the rent skewing requirement to "2 to 1" will eliminate this risk for such projects.

The Panel also suggests that projects be permitted to calculate the value of state and local assistance in determining whether projects meet the proposed "2 to 1" test. Many state and local governments make contributions to projects in order to lower market rate rents to make them affordable to targeted middle-income households. In such instances, there may still be a great disparity between the market rate and low-income rents, but one which does not meet the "2 to 1" test. If not for state and/or local assistance, the owners would have had to charge a higher market rent and would have met the "2 to 1" test. However, by accepting state and/or local assistance, the owner would not meet the "2 to 1" test and would still be faced with the likelihood of converting market rate units to low-income tenancy.

The panel recognizes that reducing the "3 to 1" test to "2 to 1", even with counting state and local assistance as additions to market rate rents in determining whether a project is deep-rent skewed, does not assist many projects which will still have a substantial difference between market and low-income rents but do not meet the "2 to 1" test. For such projects, it may be necessary to adopt a new policy based upon establishing a maximum cash flow from the low-income units to which project owners are entitled. To the extent that the low-income tenants' annual income rise more rapidly than permitted, excess rent from such tenants could be utilized to provide additional assistance to low-income tenants who cannot afford rent increases to cover inflationary increases in operating expenses. HFA was able to employ such a system under the old IRC and believes it could provide a workable basis to ensure continuous compliance. However, the modest amendments proposed above to the deep-rent skewing rules would provide needed relief to several major population centers.

2. SINGLE-FAMILY CHANGES

a. Remove the Single-Family Program's Termination Date

The Tax Act placed a termination, or "sunset" date of December 31, 1988 on the MRB program. Given the decline in homeownership affordability, the program's continuation is of vital importance.

Due to the imposition of the private purpose bond volume cap, the extension of this program cannot increase overall bond volume. Rather, extension simply gives states another option as to how to use their limited amount of bond volume. Such decisions are clearly within the purview of state government.

Along with the ability to issue MRB's, current refundings should also be extended. Current refundings enable responsible debt management and maximize program effectiveness without increasing overall levels of outstanding debt.

b. Income Limit Adjuster

The MRB program is also affected by income limits which the Tax Act sets without reference to local housing costs. In those areas of the State where the average family has only half the income required to purchase the average home, MRB financing is of little use because it cannot nearly close such a large gap. To reach the homebuyers' market in these areas, this panel recommends deriving income limits based on an affordability calculation using reasonable underwriting standards and the prevailing mortgage rate.

The construction cost index proposed as an income limit adjuster for the multi-family program is not appropriate for single-family because this program is not solely production oriented. Often the purchase of pre-existing homes is a more cost-effective use of bond-financed mortgages.

The "reasonable underwriting standards" proposed to calculate the income limit include a 5% down payment, a 30-year loan term, and a 25% housing expense-to-income ratio. The 5% down payment and 30-year loan term are the conditions of most MRB-financed mortgages and are widely accepted in the mortgage industry. The 25% expense-to-income ratio is used by the National Association of Realtors to determine housing affordability. "Expense" includes principal and interest payments.

The "prevailing mortgage rate" is one percent less than the national average fixed contract mortgage rate estimated by the Federal Home Loan

Bank Board (FHLBB) during the month preceding the Treasury Department's publication of income limits. The FHLBB estimate is based on a survey of major mortgage lenders and reflects the commercially available rates for conventional mortgages. The 1% adjustment recognizes that, as a rule, tax-exempt financed mortgages are available at less than commercial rates.

The effect of this change is to permit purchasers in high-cost areas a chance for MRB mortgages. It does not increase the purchase price limits for MRB-financiable homes. It only raises the income limits in a few areas to permit the purchase of moderately priced homes within the current MRB purchase price limits.

This formula preserves Congress' intent of targeting MRB financing to moderate- and lower-income households. It simply recognizes the reality that a decent home in one part of the country may cost vastly more in another, where land, labor and materials are more expensive. It would ensure that low- and moderate-income families in all parts of the country can use these programs to become homeowners and build communities.

c. Use of Bond-Financed Mortgages to Purchase Newly-Constructed Two-Family Homes

Under current law, MRB-financed mortgages may be used to purchase new or existing single unit homes. Multiple unit dwellings, up to four units, at least five years old, may also be purchased, so long as at least one unit is owner-occupied. Newly-constructed multiple unit structures now are ineligible for MRB financing.

A change in the law to permit the use of MRB-financed mortgages to purchase newly-constructed two-family homes would provide a new opportunity for low- and moderate-income households -- both purchasers and renters -- to secure adequate and affordable housing.

In our nation's cities and in many of our suburban communities as well, the search for decent and affordable new housing for low- and moderate-income Americans is hampered not only by high costs, but also by declining availability. Many communities are encouraging the development of two-family homes to help solve these problems.

Two-family homes have traditionally been an entry to homeownership for lower-income families because the rental income enables the owner to meet monthly mortgage payments. Among the additional advantages of two-family homes are that they cost less per unit to build, provide affordable rental units and use land efficiently.

Enactment of a provision permitting the purchase of newly-constructed two-family houses would provide a source of housing for prospective homebuyers at even the lowest qualifying income levels. At the same time, expanded use of two-family residences would create a new source of low- and moderately-priced rental housing.

3. BOND RESTRICTIONS

a. Remove State and Local Contributions from Consideration for Purposes of Determining Arbitrage Rebate Amounts

The Tax Act significantly tightened the arbitrage restrictions governing housing bonds. Arbitrage is the concept of investing bond proceeds for short terms prior to their use for the designated purpose. Under prior law, a "minor portion" of what was defined as gross proceeds of a bond -- basically any funds pledged to the bond regardless of their source -- were exempt from the yield restrictive arbitrage limitations. The Tax Act did away with the "minor portions" test.

Previously, bond issuers were able to consider at least a part of their own cash pledges, those of the state or local government and those of the builder as within the "minor portion". Since this is no longer possible, investment of these proceeds is now yield restricted. Should the investments return an amount greater than the restriction permits, the difference must be rebated to the Federal government. Since these funds are in no way traceable to the Federal government, this is unduly limiting. While this panel recognizes the Congress' legitimate desire to limit arbitrage earnings, there is no valid purpose to limiting the earning potential of other non-Federal funds.

Put simply, if the City or State of New York contribute funds for a bonds financed low-income housing project, and these funds are invested for a short time prior to their use, the earnings must be turned over to the Federal Treasury.

While the reinstitution of the "minor portions" rule would be the easiest way to remove this limitation, to do so might result in abuse. Therefore, it is recommended that amounts pledged to a bond issue by a government entity be excluded from the definition of gross proceeds.

F. CONCLUSION

This Panel has attempted to suggest very limited changes to the tax-exempt bond housing programs which were drastically altered by Congress in the Tax Act. If adopted, we believe they will help to once again make tax-exempt finance a useful tool for the State and City in our efforts to produce affordable housing. Both the State and City have contributed and will continue to make available their own direct and indirect resources toward this goal. We ask only that the Congress give us the flexibility to utilize tax-exempt financing to continue to responsibly address our future housing needs as we have in the past. We look forward to working with Senator D'Amato on these and other important housing issues in the future.

Respectfully submitted,

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4. "Housing Backgrounder", National Association of Homebuilders, 1987, p. 19.

5. Ibid., p. 19.

6. "Toward the 21st Century: Housing in New York City", 1987. The Commission on the Year 2000, p. 81.

U.S. Senator Al D'Amato
of New York

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D'AMATO PROPOSES TAX INCENTIVES FOR HOUSING

U.S. Senator Alfonse M. D'Amato (R-C-NY) said today that the elimination of federal tax incentives for housing has "exacerbated a housing crisis that will result of the disappearance of 1.8 million subsidized units by the year 2000."

D'Amato, Ranking Member of the Senate's Housing Subcommittee, proposed the restoration of federal housing tax incentives and reform of HUD administered programs, which have been cut from $30 Billion in 1980 to $7.1 Billion in 1987.

D'Amato and Senator Alan Cranston plan to introduce legislation next month to revamp the nation's housing programs.

At a subcommittee hearing of the House Ways and Means Committee, the Senator endorsed legislation proposed by Rep. Charles Rangel that would allow owners of existing low income housing units to take advantage of the housing tax credit. The legislation would also restore the depreciation schedule to already depreciated housing stock if the owner agrees to maintain the subsidized units.

Crisis in New York:

D'Amato said the housing shortage in New York has already reached crisis proportions, affecting not only low income families, but working middle class households having difficulty finding decent, affordable housing.

The New York State Division of Housing and Community Renewal has estimated that over 1 million units are needed to fill the housing gap.

D'Amato also said that the expiration of contracts executed under New York State's Mitchell-Lama program will greatly diminish the state's middle income housing stock, affecting 84,259 units in New York City, 1109 in Albany, 3180 in Erie County, 8172 in Monroe County, and 3157 in Onondaga County.

Problem: Loss of Tax Exempt Financing

The Senator said that the limits on tax exempt financing of housing have made it virtually impossible for agencies responsible for building low and moderate income housing to do their jobs.

From 1980-1985, the responsible agencies in New York State built over 25,000 low and moderate income units. D'Amato released a report from an advisory panel composed of public and private individuals showing that not one traditional bond-financing housing unit has been built in New York si[illegible].

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The new law required bond financed buildings to have 20% of the units occupied by people at 50% of median income. Such rules are impractical in high cost areas like New York, where low-income people cannot afford to live in these buildings. If the owner were to increase the tenant subsidy, the economics of the overall project could be destroyed.

An additional problem is the recertification rules for bond financed buildings, requiring owners to certify annually that low income tenants are still low income. If a tenant no longer meets the definition of "low income", the next available unit must be given to one who does. In a rent controlled area, the recertification provisions may result in an entire building being occupied by subsidized tenants.

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Chairman **Rangel**. Thank you, Senator. I know both of you have a rigid legislative schedule, and so I will not ask any questions, but one.

Do you deal with the administration's housing policies in your paper at all?

Senator **D'Amato**. No. Not in this report. But I have spoken on this subject on the Senate floor on numerous occasions.

Chairman **Rangel**. Very good. Then I will not have to make comment on them, right?

Senator **D'Amato**. You do not.

Chairman **Rangel**. Thank you.

Senator **D'Amato**. As you see, in my prepared text, we indicate that we have gone from some $30 billion down to $7 billion as it relates to Federal housing programs.

Chairman **Rangel**. Well, that is enough for the record.

Senator, let me thank you for the leadership that you provided in the Senate, and especially on the Finance Committee, and I think it is safe to say that we on the House side, on Ways and Means, could not have gotten even where we were, if it was not for you, your staff, and your creative ingenuity in trying to get some substitute for what had been abolished.

And I am glad that you are taking time out to share your views with us this morning. Your entire statement will be entered into the record.

STATEMENT OF HON. GEORGE J. MITCHELL, A U.S. SENATOR FROM THE STATE OF MAINE

Senator **Mitchell**. Yes. I have a very lengthy statement, Mr. Chairman, which goes into quite a bit of detail, and I would like to just summarize it here, now.

First, I want to say what a pleasure it is for me to be here with you, and with Senator D'Amato. Both of you have been leaders in the area of housing generally, recognizing the critical national problem that exists, and I look forward to working with you as we attempt to recreate what has been lacking in this country for this decade, and that is a realistic housing policy.

And I congratulate you for holding the first congressional hearings on the low-income housing tax credit. As you know, no hearings were held before the program was enacted as part of the Tax Reform Act of 1986, an unusual procedure for such a complex program, depending as it does on the combination of special tax rules, with various housing laws.

So, it is important, now, to take a look at this legislation, to see if the law should be changed, to become an effective and workable tool in developing low-income housing.

I believe the basic concept of a multiyear tax credit targeted to rent control units occupied by low-income tenants is sound and should be preserved. What is not clear is whether the credit creates a sufficient incentive to replace the incentives that existed in prior law.

Certainly, the record for 1987 is not encouraging. Credit activity was relatively minor. Even at the low $1.25 per capita credit allocation, only some 20 percent of the State volume cap was actually allocated.

In Maine, the State housing agency made a determined effort to educate developers and promote the credit, yet it was able to allocate only about 14 percent of its credits, producing only 96 units in four projects, and all of them were built under the Farmer's Home Administration program benefiting from scarce rental subsidies.

The problems with the low-income housing tax credit fall into two categories: programmatic problems and investor problems. The pending technical corrections bill includes some modifications to the credit, which while perhaps not technical in the truest sense, are consistent with the original intent.

These changes will help make the credit more workable. There are also a number of provisions which Ways and Means, and Senate Finance included in the miscellaneous tax packages last year, but these changes will not suffice.

One important and immediate issue is the carryover of credits to a succeeding year. Current rules, as modified in technical corrections, in essence require the credit to be allocated to the year the project is placed in service.

That inflexibility does not reflect the myriad financing and construction delays which are the real-world experience in multihousing construction.

The rule is bad housing policy, because it creates a bias against new construction, substantial rehabilitation, and, indeed, any difficult project demanding multiple financing sources and major construction.

The Senate approach was to broaden the factors Treasury must consider in granting a waiver of the carryover rule, but that approach was tailored more to revenue constraints than to a workable solution.

Under this regime, developers are still constrained by contingencies not in the Senate bill, and by the uncertainties attending any individual waiver provision. The House bill's approach is preferable in this respect.

When Congress created the low-income housing credit program, it also wrote passive-loss limitations which make it difficult to attract investors to the credit.

These rules shrink the universe of potential investors for low-income housing. The $200,000 income limit, in a program designed to provide tax benefits over a decade, means that only those with sufficient funds to invest, and who also assume earnings of under $200,000 a year for the decade, can invest in the low-income housing tax credit partnership.

This rule will, in the long-term, significantly reduce the efficiency of the credit. A smaller investor pool means higher syndication fees and a higher rate of return, so more of each credit dollar will have to go to the investor and for syndication overhead than in to the low-income housing.

To the extent that the universe of investors can be expanded to make more equity funds available, then more of the credit will go into the project and more low-income housing development will occur.

Yesterday, Senator Danforth, I, and others introduced in the Senate legislation to replace the passive-loss rule with a tougher general business credit limitation to cap all tax credits at $20,000 plus 20 percent of tax liability.

Identical legislation has been introduced in the House. This should increase the number of potential investors while reasonably limiting the amount of credit each taxpayer can use. The tax credit approach can be an effective way to attract investment dollars to low-income housing, but before it fulfills that promise, more fundamental structural changes may be warranted in next year's extension of the program.

Its essential element should be retained, but there should be more State flexibility to allocate credits to specific projects.

State administration of the credit program is an essential policy element that deserves to be emphasized and retained. It is direct State participation which allows us to understand the complexities of the program, evaluate its success, and develop improvements.

Active State involvement in monitoring also makes more likely an efficient and abuse-free program.

Now, Mr. Chairman, according to our State agency, even with rent supplements, the credit alone is unworkable in 19 out of 20 statistical population areas. Further subsidies which are quite scarce, as we know, are needed.

You face similar hurdles in New York City, where the ratio of construction costs to median-income is far higher than the national average.

Maine is trying to solve the problem with a housing trust fund financed by a new real-estate transfer tax. The State has designed a multihousing program using the credit with tax-exempt bonds and deferred-interest loans, but still, it has not been easy to attract developers.

What we now have in place is a national housing credit which cannot be adapted to the needs of individual regions. The State housing agencies have the expertise, and must be given greater discretion to fashion programs which reflect local needs.

The credit should be changed to allow States to increase the credit amount for new construction and substantial rehabilitation above the 30 percent present value of current law.

While 1987 credit activity was below the maximum amount States could allocate, at some point, the per-capita credit allocation will have to be increased because that limit will not begin to address national housing needs.

If we take the District of Columbia as an example, with more than 600,000 people, under the existing credit limit there will only be 200 new low-income housing units that could be constructed annually. That, obviously, must change.

Finally, I applaud the low-income housing community for its efforts to make the credit work. In Maine, our housing authority has gone to great lengths and yet has achieved only limited success. This is typical nationwide.

A dedicated and professional group of individuals are working hard to make the most of scarce Government and private resources to provide shelter for all Americans, and a central requisite of any decent, humane society.

And they are doing it without fanfare that attends our sporadic focus on the homeless, and they are working against a cruel conventional wisdom which holds that money is not the answer to social problems.

Mr. Chairman, I look forward to working with you, the Members of the Committee, and my friend, Senator D'Amato, in the coming months to make this credit meaningful, so we can begin to address what is one of our most serious national problems.

[The statement of Senator Mitchell follows:]

STATEMENT OF SENATOR GEORGE J. MITCHELL
HEARINGS ON LOW-INCOME HOUSING TAX CREDIT
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
MARCH 2, 1988

Thank you. It is a pleasure to be here to testify on the operation of the low-income housing tax credit.

I first want to thank the Chairman for holding these hearings and for the leadership he has shown on low-income housing issues in Congress.

While, there appears to be much concern in Congress and in society for the issue of housing and the homeless, too often that support is in the abstract and does not translate into support for specific programs to address pressing housing needs. That seems particularly true with respect to the low-income housing tax credit where it has been so difficult to establish an effective and workable program. The low-income housing credit is not a politically popular program so every measure of support in Congress is quite important.

This marks the first Congressional hearings on the low-income housing tax credit. There were no hearings prior to the establishment of this program in the Tax Reform Act of 1986. That is an unusual way to create a new federal program, particuarly one as complicated as the low-income housing credit which depends on the combination of special tax rules with various housing laws.

Because of the unusual environment in which the credit was created, and the inherent complexity of the program, we should be willing to take a fresh look at the law to determine what changes are in order to make the credit an effective and workable tool in low income housing development.

Nevertheless, I continue to believe the basic concept of a multiyear tax credit -- targeted to rent controlled units occupied by low-income tenants -- is correct and should be preserved.

As a Member of the Senate Finance Committee where the credit idea originated, I played a role in its development. And when I travel in Maine and across the country, I often speak with people involved in low-income housing development who want to know more about the program and what Congress intended. When they approach me about the credit, I don't know whether to take credit for the new program or accept the blame because I have had to endure much criticism of the program.

Back in the Spring of 1986 when the Senate Finance Committee first began to explore the idea of a tax credit for low-income housing, the concept of the credit was quite different than what was finally enacted into law. The credit concept was first discussed as an alternative to the multifamily bond program, much as the mortgage credit certificate was created as an alternative to the mortgage revenue bond program.

It was a concept which I believe would have been part of the final Committee bill had the entire tax reform process not faltered in the Finance Committee. The tax reform bill was reconstructed with very low tax rates and new restrictions on passive losses. Since those changes took the value out of the existing equity incentives for low-income housing, it was necessary to take another look at the credit concept.

Rather than remaining an alternative to tax-exempt financing -- a substitute for a debt subsidy -- the credit began to be regarded as a substitute for existing equity subsidies. The credit was ultimately enacted for that purpose. In fact, the automatic linkage of the credit and tax exempt bonds is proof of that intent.

With that necessary recounting of history, my concern about the credit can be simply stated: as currently established, is there enough value in the credit to be an equity incentive capable of replacing the incentives in prior law?

Certainly, the record for 1987 is not encouraging; credit activity has been relatively minor. Congress established a very modest program permitting only $1.25 of credit allocation per capita. Yet, even at that low level actual utilization last year was quite low. Only about 20% of the state volume cap was actually allocated -- even less was probably used.

The State of Maine has an excellent housing agency which has made a determined effort to educate developers and promote the new credit in Maine. Yet, in spite of those efforts, last year the state agency allocated only about 14% of its credits which produced only 96 units in four projects. All of those units were built under the Farmers Home Administration program and benefited from scarce rental subsidies.

Start-up delays are understandable with any new program -- particularly one as complicated as this which requires a knowledge of both housing and tax law. It has been difficult for state administrators to figure the program out when Treasury has not yet provided full guidance. It has been even more difficult to educate developers, financers, and investors that the program can work with reasonable returns and risks.

The selling of the credit program has been made all the more difficult by tax reform which retroactively repealed prior law tax treatment through the passive loss rules. No where was that effect more retroactive and unfair than with respect to low-income housing development where investors bargained for the tax benefits, not for the cash flow or property appreciation. Developers and investors are understandably wary that Congress could again pull the rug out from under them.

That points up the need for Congress to give assurance that the credits are guaranteed for ten years regardless of other changes in federal law. I have no doubt that is the case, but if there is any way Congress can give better assurance to the public, we should provide that assurance.

That also points up the need for Congress to give an early expression that the low-income credit program will be extended beyond its 1989 expiration date. As a practical matter that signal is almost impossible to give prior to legislative enactment of an extension but we should be aware that the sunset date in this program inhibits further development because of the long lead time necessary to plan and develop multifamily housing. When we do extend this program next year, it should be extended indefinitely so we do not create the situation where low-income housing development ebbs every three years because of uncertainty that the program will be extended.

Current problems with the low-income housing tax credit can be divided into two categories -- programmatic problems and investor problems.

The Technical Corrections bill now pending in Congress includes a number of necessary modifications to the credit which, while not technical in the truest sense, are consistent with the original intent. These changes will address a number of outstanding questions and help make the credit more workable.

There are also a number of provisions which the Ways and Means Committee and the Senate Finance Committee included in the miscellaneous tax packages last year. While these provisions are more substantive than the items in Technical Corrections, they are still consistent with the orginal credit. Those miscellaneous provisions should be resurrected this year as part of the Technical Corrections bill.

The provisions approved by the Senate Finance Committee are not intended to be the answer to all of the problems with the credit. We were particularly constained by revenue considerations when putting our package together.

One of the most important immediate term issues which should be addressed in the question of carrying over credits to a succeeding year. Current rules, as modified in Technical Corrections, pretty much require the credit to be allocated to the year the project is placed in service regardless of mitigating circumstances. That inflexible rule does not reflect the reality of multihousing development where myriad delays in securing financing and constructing a project can and do occur.

The effect of the current rule is to prevent a state agency from allocating 100% of the credit in any one year because many projects will be forced to request a later allocation at the end of the year. That means we can not even get full use of the meager credit allocations permitted under current law.

The carryover rule is bad housing policy because it creates a distinct bias against new construction, substantial rehabilitation, and indeed all difficult projects where a variety of financing sources and major construction is necessary to create new housing.

The Senate approach was to provide some greater certainty by broadening the factors Treasury must take into account in granting a carryover on a case by case basis. But that proposal was made because of revenue constraints, not because it provides a workable solution to the carryover problem. Developers will still be constained by contingencies not included in the Finance bill and, in any event, the risk that a waiver will not be granted interferes with project development. I much perfer the House approach although I think we should avoid any reduction in the limited credit authority in current law.

The tax credit approach can be an efficient mechanism and effective means of attracting investment dollars into low-income housing. Before that is the case, however, I believe we must be prepared to consider more fundamental structural changes to the credit when it is extended next year. Those changes should preserve the essential nature of the credit -- including income targeting and rent limitations -- while giving states more flexibility in allocating credits to a particular project.

The experience of the Maine State Housing Agency is instructive. Maine is a relatively low median income state with high housing costs resulting from the cold climate and recent population growth which has inflated land values.

The design of the credit makes its utilization in Maine all the more difficult because -- compared to other states -- rental payments must be lower while housing costs are higher.

According to our state housing agency, even with rent supplements, the credit is unworkable in 19 of our 20 statistical areas without the addition of further subsidies; subsidies which are quite scarce at the federal level.

Maine is attempting to overcome these problems. The state has established a special housing trust fund financed by a new real estate transfer tax. The state housing agency has used this fund to design a multihousing program which uses the credit with tax exempt bonds and deferred interest loans. It has not been easy, however, to attract developers to this program.

Mr. Chairman, you face similar hurdles in New York City where the ratio between construction costs and median income far exceeds the national average.

We have a national housing credit which cannot be tailored to the particular circumstances of each area in the country. The state housing agencies have worked hard to understand and promote the new credit. They have the expertise, and should be given greater discretion, in fashioning a credit program that reflects the needs of their states.

I believe the credit should be changed to give state allocating agencies discretion to increase the credit amount for new construction and substantial rehabilitation above the 30% present value of current law.

Although credit activity in 1987 was well below the maximum amount states could allocate, at some point as program changes are made, more and more states will be severely limited by the $1.25 per capita credit allocation permitted under current law. I believe those limits are exceedingly low and should be revised upward to reflect the severe housing needs in many areas of the country. Perhaps we should even consider setting state allocation limits to the particular housing needs of the state.

In many cases, the allocation caps cannot begin to serve the housing needs of the area. Consider the District of Columbia. With a population of around 600,000 people, the District of Columbia housing agency can allocate approximately $780,000 in tax credits annually. With the 9% credit that works out to little more than 200 new low-income housing units annually. That will not begin to satisfy the housing needs of this city.

Compare that to the historic rehabilitation credit which has no limit. According to a January 11, 1988 article in Forbes Magazine, one 260 room hotel on Fifth Avenue in New York claimed more than $14 million in rehabilitation tax credits and depreciation benefits last year. That is more than is allocated to the entire city of New York for new low-income housing development each year.

In other words, the federal government is subsidizing through the tax code palatial $400 a night rooms at just one hotel which amounts to more than the entire population of New York receives for low-income housing.

That kind of report shocks the conscience. I don't relate it as a criticism of the rehabilitation tax credit but as an example of the paucity of the new housing credit program. What kind of society is it that is willing to spend far greater tax subsidies to rehabilitate opulent buildings than to provide decent, affordable housing for its less fortunate.

Once we straighten out some of the programmatic problems identified today, the credit will be used in greater amounts and I believe we should greatly increase its allocation.

The last issue which I want to discuss deals with the relationship between the low-income housing credit and the passive loss rules.

Unfortunately, at the same time Congress created the low-income housing credit program, it created new passive loss limitations which make it exceedingly difficult to attract investors to the credit. Severe restraints were placed on the amount of the credit which could be taken, and on the income of the investor. A maximum $25,000 in loss equivalent credits can be claimed annually only by taxpayers with adjusted gross income below $200,000.

This rule severely restricts the universe of potential investors effectively excluding the market which has traditionally invested in low-income housing. The $200,000 limitation is particularly inappropriate for a credit program designed to provide tax benefits over a 10 year period. Only those persons who have enough money to invest but assume they will not earn over $200,000 for the next decade can invest in a low-income housing tax credit partnership.

That is a rather nonsensical rule which, in the long term, will interefere with the efficiency of the tax credit causing the tax subsidy to be eaten up in investor returns and syndication expenses. Because the investor market is so limited, syndication fees will have to be higher to find eligible persons and a higher rate of return will have to be provided to get those persons to invest.

That means that more of each credit dollar will wind up in the pockets of the investor and in sydication overhead than in the low-income housing project. To the extent that the universe of investors can be made larger so that more equity funds are available, more low-income housing development will occur.

This is a particularly difficult issue to deal with because the passive loss rules are a central element of tax reform and Congress is reluctant to modify those rules. Tax rates were reduced so low that the tax system cannot tolerate significant tax avoidance.

I believe, however, that the low-income housing credit presents a somewhat unique case. More so than with any other investment, investors "pay" for their tax breaks by putting money in a project that can produce little if any cash flow or appreciation. Although taxes may be reduced, net after tax income is comparable to that earned on other investments of similar risk. Furthermore, the alternative minimum tax is an effective back stop to overutilization of the credit.

Yesterday, Senator Danforth, myself, and others introduced legislation which, among other things, would make the passive loss rules inapplicable to the the low-income housing tax credit. The passive loss rule would be replaced by a tougher general business credit limitation which would limit all tax credits to $20,000 plus 20% of tax liability.

This should greatly increase the number of potential investors while limiting the amount of credit each taxpayer can use.

As a final point I would like to applaud the low-income housing community for its efforts to make the credit work. In Maine, the State Housing Authority has gone to great lengths to acheive limited success. I know that this is also the case nationwide where a dedicated group of individuals are working hard to make the most of scarce government and private resources to provide shelter to less fortunate Americans.

During the course of the continueing discussions on credit improvements, we must not lose sight of another important housing policy which we adopted in the original program design. State governments must continue to be administrators of the credit. Quite simply, it is their direct participation which will allow us to understand the complexities of the program, evaluate its success, and design the necessary improvements. Their active involvement and monitoring capacity will ensure an efficient, abuse-free program.

In addition, a program which links the credit with states will accelerate the very clear trend of states playing a much more vital role in solving the housing problems of their citizenry. Given their ever-diminishing role at the federal level, the magnitude of the problem requires that states be more present financially and creatively.

I thank the Chairman for his efforts and pledge my personal support and continued participation in this effort.

Chairman **Rangel**. Senator, both Senators, let me thank you again, and our housing policy, as a nation, is a disgrace. I never thought that we would have to go to the Tax Code in order to find some shelter for the disadvantaged and even the moderate income, but I am confident that we will have to come up with some other type of solution to this problem.

I have cosponsored the Kennelly legislation which is the companion bill that you have introduced in the Senate, and maybe with the dedication, as you indicated, of those in the industry who have really come forward, to try to make this "only game in town" really workable, that we can find some solution, or at least some partial solution to the crisis.

I want to thank both of you, and welcome Mr. Dorgan who has joined us. I shared with him your time restraints.

Senator **Mitchell**. Thank you, Mr. Chairman.

Senator **D'Amato**. Thank you, Mr. Chairman.

Chairman **Rangel**. Senator, Mr. Dorgan is going to chair the next panel for me while I talk with you before you go back.

Mr. **Dorgan**. The committee will next call the panel consisting of Eugene Steuerle, Deputy Assistant Secretary of the U.S. Department of Treasury; D. Duncan MacRae, General Deputy Assistant Secretary for Policy Development and Research, Department of Housing and Urban Development; and Vance Clark, Administrator of Farmers Home Administration.

We would like to welcome all of you to the committee. We would advise you that we will include your entire statement as a matter of the permanent record of the committee, and ask that you summarize your statement, and we would begin with Mr. Eugene Steuerle, Deputy Assistant Secretary of the Treasury Department.

Mr. Steuerle, welcome. You may proceed.

STATEMENT OF C. EUGENE STEUERLE, DEPUTY ASSISTANT SECRE- TARY (TAX ANALYSIS), U.S. DEPARTMENT OF THE TREASURY

Mr. **Steuerle**. Thank you, Mr. Dorgan.

As you indicated, I will summarize my statement and submit the rest of it for the record.

I am pleased to have the opportunity to present the views of the Treasury Department on the low-income housing credit, and on proposals to provide additional tax relief to certain owners of low-income housing.

Although the Tax Code has a limited role in the direct provision of low-income housing, tax reform made a significant contribution to the ability of poor working families to afford decent housing.

The Tax Reform Act removed millions of poor families from the Federal income tax rolls. It expanded, by several billion dollars, the earned income tax credit which benefits working poor households.

Moreover, the Tax Reform Act replaced the panoply of rental housing tax expenditures under prior law with a new low-income housing tax credit, and tax-exempt bond financing, both of which are better targeted to the truly needy.

We believe that taken together, these provisions represent a strong commitment to the needs of poor families.

The administration supported the low-income housing credit enacted in the Tax Reform Act of 1986. We will be closely monitoring that credit during 1988 and the early part of 1989, as more taxpayers take advantage of this important incentive for investment in low-income rental housing.

During the period between now and its scheduled expiration at the end of 1989, we would like to work with Congress in determining the fairest and the most effective way of assisting low-income individuals in meeting their rental housing needs.

With the exception of certain technical corrections, we do not support any substantive changes to existing tax incentives for rental housing at this time.

Furthermore, we oppose H.R. 3663, because it would provide limited benefits to the poor relative to the costs that would be incurred.

The focus of my testimony is on the fairest and most effective ways of assisting low-income individuals. In that regard, a very important criterion for examining the current and proposed tax incentives is the following: for each $100 of revenues involved, how much in the way of housing benefits actually go to low-income families?

If the tax incentives are not adequately designed or targeted, much of the benefits could go to non low-income renters, to investors, existing landlords, land owners, or developers and syndicators.

In addition, concerns about the administrability of the incentive, the effect on renters' choice of housing location, and level of services, and incentives for maintenance and retention of the housing as low income must be considered.

The motivation behind the low-income housing credit was that the tax provisions for low-income housing under prior law were thought to be inefficient. Congress was concerned that the tax preferences under prior law were not effective in providing affordable housing to low-income individuals. These preferences were uncoordinated and the amount of tax subsidy was not directly related to the number of low-income individuals being served.

As an example, bond-assisted projects often benefited moderate and upper income households, according to a 1986 General Accounting study. There was no incentive for recipients of tax subsidies to provide more low-income units than the minimum amounts, nor was there any direct incentive to limit rents.

On the other hand, the new credit assists investment in rental housing serving individuals near the poverty level. Tax-exempt bond provisions were also modified to conform with the tighter requirements of the low-income housing credit.

At this time, Mr. Chairman, we have inadequate data to evaluate the first year's experience with the low-income housing credit. The first income tax returns claiming this credit are only now being filed with the Internal Revenue Service.

However, evidence does suggest that the first-year usage of the credit has been only moderate. New programs often start up slowly, for a number of reasons. First, new construction and substantial rehabilitation projects may take several years between planning and execution. Second, information about new programs and their benefits may take a year or two to be widely disseminated. And finally, tax reform changed the way that low-income housing is financed. Syndicators must now seek investors with lower incomes and divide projects into smaller shares. Corporate ownership of low-income housing may also increase significantly.

Another source of delay, as you know, is uncertainty about the implementation of the new credit. Uncertainty about technical corrections to the 1986 act is a significant impediment. The complexity of the new law has required a number of regulations. To facilitate this process, we urge Congress to expedite passage of technical corrections.

At the same time, the Treasury Department will continue to monitor experience with the low-income housing credit during 1988 and the early part of 1989. We expect to see increased use of the credit as the rules are clarified, and as investors and developers become more familiar with the credit.

We also welcome this opportunity to assess the likely strengths and weaknesses of the low-income housing credit in the context of overall tax and housing policy. We do have some concerns about the efficiency and equity of the credit that need further examination over time.

The low-income housing credit is a significant improvement over prior law. Based on our estimates, the low-income housing credit by itself is more generous than the combination of accelerated depreciation and tax-exempt bond financing under prior law. Moreover, current tax benefits are targeted solely at low-income units. Targeting of the incentive is important because the efficiency of rental-housing incentives improves dramatically with targeting.

Nonetheless, we have concerns about the cost per unit of housing being created. One study of Federal housing incentives in the 1960's and 1970's, for instance, found that about 65 percent of Government-subsidized low-income housing units were offset by reductions in market supply of housing.

Also, 75 percent of low-income housing is not Federally subsidized. We need to be sure that tax policies do not threaten the viability of this major segment of the market.

An assessment of low-income housing tax incentives will also require a determination of what percentage of the cost of the credit and tax-exempt bonds accrues to the benefit of low-income families. A CBO study estimated, at one time, that less than half of low-income housing tax subsidies under prior law actually reached the builder/developer or low-income renter. In addition, we are concerned that the tax credit may provide little or no incentive for maintenance. If units receiving the credit rent at below-market levels, landlords could conceivably allow projects to deteriorate without losing tenants. And finally, households substantially below the poverty level are actually unlikely to benefit from the credit.

Another source of inefficiency is that the low-income housing credit may not result in a quality of housing, or location, that is appropriate or desired by the low-income renter. Thus, even if the full value of the credit were passed along to these tenants, the value to the renter would be less than the amount of the subsidy. For instance, the assisted housing may not be near jobs or public transportation that poor households need. It may not provide the amenities that poor households want, but nonetheless have to pay for through the credit.

The administration has addressed these concerns by reemphasizing its commitment to rental housing vouchers in the 1989 budget.

We are also particularly concerned that the low-income housing credit not become the dominant mechanism for assisting low-income housing. The annual cost of the credits could be $3 billion, if fully phased in on a permanent basis. In light of the relative efficiency of vouchers, we question whether so much of the housing assistance for the poor should be channeled through the tax-credit mechanism.

Mr. Chairman, the remainder of my testimony deals mainly with H.R. 3663, which is going to be the focus of a future hearing.

Would you like me to proceed with that, or would you prefer to go on to the other testimonies—with respect to the credit itself.

Mr. Dorgan. Why don't you go ahead and proceed, Mr. Steuerle.

Mr. Steuerle. H.R. 3663 is designed primarily to encourage the preservation of existing Government-assisted multifamily low- and moderate-income housing through additional tax incentives for the owners of the housing. The tax incentives provided by this bill are intended primarily to address the loss of low-income housing that may occur when Government-assisted projects become eligible to prepay mortgages and terminate low-income occupancy.

The administration is committed to preserving existing HUD-assisted housing for low-income tenants to the maximum extent practicable and at a cost commensurate with the amount of housing provided. For this reason, the administration has supported provisions in the Housing and Community Development Act of 1987 to provide nontax incentives for owners who may prepay and convert the housing to market-rate rental occupancy. In addition, a technical correction to the low-income housing tax credit, supported by the Treasury Department, would waive the 10-year holding period requirement for existing federally assisted housing in circumstances where federally assisted and federally insured low-income buildings would otherwise be converted to serve non-low-income tenants.

Although we support present measures to preserve existing low-income housing, we believe that the current budget situation and the new housing law and tax credit waiver provision provide an opportunity to reassess the proper mix of housing programs and tax incentives to preserve low-income housing. For these reasons, we are opposed to substantive changes in the tax law in H.R. 3663 that provide additional incentives.

In addition to our general concerns, we have a number of specific comments. We are especially concerned with windfalls that might inure to the benefit of owners rather than to low-income tenants under this bill.

Just to give one example, Mr. Chairman we strongly object to provisions to restore basis. The cost of both the project and the improvements presumably already have been capitalized and depreciated. The effect of this special basis provision would be to permit a double deduction of the cost of the housing and improvements. Such a departure from long-established principles of tax law and accounting is not warranted.

Moreover, the amount of tax benefit from the restoration of the basis would bear no relation to the amount of low-income housing provided. Such a subsidy would operate in an arbitrary manner, resulting in tax benefits unrelated both to the number of low-income individuals served and the current economic situation of the particular project.

We have similar concerns with other sections of the bill, Mr. Chairman, but I will not go into them at this point, but refer you to my testimony.

In summary, Treasury is fully committed to the reforms enacted in 1986, reforms aimed at making a fairer and more efficient Tax Code and at helping low-income individuals directly through elimination or reduction of tax payments and expansion of the earned income tax credit. In addition, we supported targeting of housing benefits to low-income individuals because previous provisions had only limited effect on the supply of housing to such individuals and often involved costs far in excess of the benefits. We remain committed to these compromises. As evidence on the tax credit becomes available, we need to examine its efficiency relative to other, more direct, ways of helping low-income individuals, such as housing vouchers and the earned income tax credit.

We do not believe that it is time to make major changes to the credit. We know too little about its effectiveness. We especially oppose provisions that would provide significant windfalls to owners of real estate and little benefit to low-income individuals. We do, however, support limited technical corrections designed to make the existing credit more workable, such as allowing a waiver to certain rules in limited circumstances in which federally assisted and federally insured low-income buildings would otherwise be converted to serve non-low-income tenants.

Thank you.

[The statement of Mr. Steuerle follows:]

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March 2, 1988

STATEMENT OF
C. EUGENE STEUERLE
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
UNITED STATES HOUSE WAYS AND MEANS COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the low-income housing tax credit and proposals to provide additional tax relief to certain owners of low-income housing. Although the tax code has a limited role in the direct provision of low-income housing, tax reform made a significant contribution to the ability of poor working families to afford decent housing. The Tax Reform Act of 1986 removed millions of poor families from the Federal income tax rolls. It also expanded by several billion dollars the earned income tax credit, which benefits working poor households. Moreover, the Tax Reform Act replaced the panoply of rental housing tax expenditures under prior law with a new low-income housing tax credit and tax-exempt bond financing, both of which are better targeted to the truly needy. We believe that, taken together, these provisions represent a strong commitment to the needs of poor families.

The Administration supported the low-income housing credit enacted in the Tax Reform Act of 1986. We will be closely monitoring the credit during 1988 and the early part of 1989, as more taxpayers take advantage of this important incentive for investment in low-income rental housing. During the period between now and its scheduled expiration at the end of 1989, we would like to work with Congress in determining the fairest and most effective way of assisting low-income individuals in meeting their rental housing needs.

With the exception of certain technical corrections, we do not support any substantive changes to the existing tax incentives for rental housing at this time. Furthermore, we also oppose H.R. 3663 because it would provide limited benefits to the poor relative to the costs that would be incurred.

The focus of my testimony is on the fairest and most effective ways of assisting low-income individuals. In that regard, a very important criterion for examining the current and proposed tax incentives is the following: for each $100 of revenues involved, how much in the way of housing benefits go to low-income families? If the tax incentives are not adequately designed or targeted, much of the benefits could go to non-low-income renters, investors, existing landlords, land owners, or developers and syndicators. In addition, concerns about administrability of the incentives, the effect on renters' choice of housing location and level of services, and incentives for maintenance and retention of the housing as low-income must be considered.

My testimony has three parts. First, I will discuss the role of the Tax Reform Act of 1986 in meeting the housing needs of poor families. Second, I will address the low-income housing tax credit. Third, I will comment on the proposed modifications in H.R. 3663.

I. Tax Reform Act of 1986 and Low-Income Housing

Two of the principal objectives of the Tax Reform Act of 1986 were fairness and reducing the extent to which the tax system interfered with the efficient decisions of individuals and businesses. The tax reform provisions affecting rental housing were generally consistent with these objectives.

Fairness was advanced by removing millions of poor households from the Federal income tax rolls and by substantially increasing and indexing for inflation the earned income tax credit. Full indexation means that these measures represent permanent gains for poor families. Experts at the Department of Housing and Urban Development (HUD) have emphasized that the problems with low-income housing are principally affordability rather than availability. Tax reform represented a tangible contribution toward the ability of working poor families to be able to afford decent housing (as well as food, clothing, and other necessities).

The new law substantially reduced the tax shelter opportunities in rental housing investment. Even when such tax shelters were in pursuit of such worthy objectives as housing the poor, they created a perception of unfairness that undermined confidence in the income tax system. Moreover, tax shelter investments in low-income housing were inefficient because much of the tax benefits accrued to high-income investors and only a fraction actually reached low-income renters.

Tax reform replaced a number of rental housing tax incentives with a single tax credit to encourage new construction, rehabilitation, and preservation of low-income housing. The new credit is directly related to the amount of low-income housing provided. The credit and the more tightly targeted rental housing tax-exempt bonds are aimed specifically at renters near the poverty level. While all subsidies are inefficient in the sense that only a fraction of expenditures actually results in a net increase in the housing stock, scholarly research on housing programs has found evidence that targeting subsidies at families near the poverty line can substantially improve their effectiveness.

II. Low-Income Housing Tax Credit

A. Low-Income Housing Tax Incentives Under Prior Law

The motivation for the low-income housing credit was that the tax provisions for low-income housing under prior law were thought to be inefficient. Congress was concerned that the tax preferences under prior law were not effective in providing affordable housing for low-income individuals. The preferences were uncoordinated and the amount of tax subsidy was not directly related to the number of low-income households being served. There was no incentive for recipients of tax subsidies to provide more low-income units than the minimum amounts, nor was there any direct incentive to limit rents.

One primary tax benefit for low-income housing was accelerated depreciation at 200 percent declining balance over 15 years. Recapture of accelerated depreciation of low-income housing was phased out after 100 months. In addition, construction period interest and taxes could be expensed for new low-income housing. Substantial rehabilitation expenditures were amortized over five years. Low-income housing investors were excepted from the at-risk rules for real estate. In combination with the higher marginal tax rates under prior law, these accelerated deductions resulted in large tax reductions for owners of low-income housing projects that were assisted by HUD or the Farmer's Home Administration (FmHA). To qualify as low-income housing, at least 85 percent of tenants had to have incomes below 50 percent of area median income.

Other tax benefits assisted rental housing generally. A key feature was the preferential tax treatment of debt-financed investments. Since real estate investments were often highly leveraged, interest expense was large relative to current income, resulting in large tax deductions. Much of the income attributable to the interest expense was later realized as capital appreciation on sale, which was taxed at the lower tax rates on long-term capital gains. Although tax-exempt bond financing was nominally directed at low-income rental housing, the income limits were well above the poverty line and only 25 percent of tenants had to meet the income restrictions. The result was that most bond-assisted projects benefited moderate- and upper-income households according to a 1986 General Accounting Office study. 1/ In addition, prior law provided for accelerated depreciation for non-low-income rental housing and commercial real estate at 175 percent declining balance over 19 years and 10-year amortization of construction period interest and taxes.

B. Low-Income Housing Tax Incentives Under Present Law

The Tax Reform Act of 1986 replaced the panoply of poorly targeted tax incentives under prior law with a low-income housing tax credit. This credit assists investment in rental housing serving individuals near the poverty level. Tax-exempt bond provisions were modified to conform with the tighter requirements of the low-income housing credit.

The low-income housing tax credit is allocated by State agencies to owners of residential rental projects providing low-income housing. Project owners must agree to rent at least 20 percent of their units to low-income households for 15 years, subject to rent restrictions. Qualified projects are eligible for tax benefits of up to 70 percent of the present value of the initial investment in low-income housing, paid over a 10-year period.

New construction and qualified rehabilitation expenditures for non-federally subsidized low-income housing units are eligible for a tax credit of up to 70 percent of the initial low-income housing investment. Because the credit is paid over a 10-year period, the annual credit for qualified new construction investments made in 1987 was 9 percent of the initial investment. If tax-exempt bond financing or certain other government subsidies are used to finance the project, then a 30 percent credit rate applies. Purchases of existing units that were last placed in service more than 10 years ago are also eligible for a 30 percent credit. If owners provide more low-income housing units than agreed to in the initial application with the State, they are eligible for credits at two-thirds of the initial rate for the cost of the additional low-income units.

The credit is only available for units rented to households near or below the poverty level. In general, a project owner can choose one of two minimum qualifying criteria: (1) 40 percent of units must be rented to households whose incomes do not exceed 60 percent of area median income or (2) 20 percent of units must be rented to households whose incomes do not exceed 50 percent of area median income.

Rents on qualifying low-income units must not exceed 30 percent of qualifying income (either 50 percent or 60 percent of area median as elected by project owner).

Designated state agencies authorize credits to qualifying projects subject to an overall cap of $1.25 per capita of new

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1/ U.S. General Accounting Office, Rental Housing: Costs and Benefits of Financing with Tax-Exempt Bonds, 1986.

annual credit authority per year. In 1987, the total credit authority was approximately $300 million. States may not generally carry over unused credit authority except in 1989. One-tenth of the State cap is set aside for projects that are syndicated by qualified tax-exempt organizations.

Projects that fail to provide the agreed upon percentage of low-income housing units, exceed qualifying rent limits, or are transferred without posting suitable bond are subject to full or partial recapture of the accelerated portion of the credits claimed. For projects that fail to comply in the first 11 years, 1/3 of credits are recaptured with interest. The recapture fraction phases out between years 12 through 15.

C. Current Experience With the Low-Income Housing Tax Credit

We have inadequate data at this time to evaluate the first year's experience with the low-income housing tax credit. The first income tax returns claiming low-income housing credits are only now being filed with the Internal Revenue Service. However, experience with other new tax incentives, as well as survey results commissioned by the National Council of State Housing Agencies, would suggest that first-year usage of the credit has been only moderate.

New programs often start up slowly for a number of reasons. First, new construction and substantial rehabilitation projects may take several years between planning and execution. Second, information about new programs and their benefits may take a year or two to be widely disseminated and incorporated in investor's and developer's practices. Finally, tax reform has changed the way low-income housing is financed. The passive loss limitations and alternative minimum tax limit the ability of wealthy individuals to reduce their tax liability through tax shelters, including rental housing tax shelters. Thus, syndicators are seeking investors with lower incomes (below $200,000) and dividing projects into smaller shares. Tax reform also changed the attractiveness of low-income housing for corporations relative to individual tax shelter investors; corporate ownership of low-income housing may increase significantly.

Another source of delay is uncertainty about the implementation of the new credit. Uncertainty about technical corrections to the 1986 Act is a significant impediment. Moreover, the complexity of the new law has required a number of regulations. To facilitate this process, we urge the Congress to expedite passage of technical corrections. Passage of technical corrections should not again be delayed by other unrelated considerations.

The Treasury Department will continue to monitor the experience with the low-income housing tax credit during 1988 and the early part of 1989. We expect an increase in use of the credit as the rules are clarified and as investors and developers become more familiar with the credit.

D. Evaluation of the Low-Income Housing Credit

We welcome the opportunity to begin to assess the likely strengths and weaknesses of the low-income housing credit in the context of overall tax and housing policy. While the low-income housing credit is a clear improvement over prior law, we do have some concerns about the efficiency and equity of the credit that need further examination by HUD, Treasury, and the Congress.

The low-income housing tax credit is a significant improvement over prior law. Based on our estimates, the low-income housing credit by itself is more generous than the combination of accelerated depreciation and tax-exempt bond financing under prior law. Moreover, current tax benefits are targeted solely at low-income units. Under prior law, most of the tax incentives for rental housing supported moderate- and nupper-income rentals. Tax reform targeted the incentives toward housing for families near or below the poverty level.

Targeting of the incentive is important because the efficiency of rental housing incentives--i.e., the extent to which they can permanently increase the stock of housing rather than simply replace market-supplied housing--improves dramatically with targeting. While there is limited empirical evidence, one study 2/ of federal housing incentives in the 1960s and 1970s found that about 65 percent of government-subsidized low-income housing units were offset by reductions in market-supplied housing. The study found that subsidies for moderate-income housing resulted in no statistically significant long-run increase in housing supply.

Nonetheless, we have concerns about the cost per unit of housing created. First, as noted, this type of subsidy still results in some displacement of market-rate rental housing. Some subsidized units simply replace units that would have been available in the absence of federal assistance. Currently 75 percent of low-income housing is not federally subsidized. We need to be sure that tax policies do not threaten the viability of this major segment of the market.

An assessment of low-income housing tax incentives will require determination of what percentage of the cost of the credit and tax-exempt bonds accrues to the benefit of low-income families. A 1977 CBO study 3/ estimated that less than half of low-income housing tax subsidies under prior law actually reached the builder/developer or low-income renter. Lower tax rates may limit the extent to which high tax bracket investors can earn windfall returns and overhead costs may be reduced to the extent that corporations increase their ownership of low-income housing. A complete accounting of the costs also must include the additional administrative costs borne by the IRS, HUD, and State housing agencies.

Second, the low-income housing credit may have some undesirable effects. The credit includes no incentive for maintenance. If units receiving the credit rent at below market levels, landlords could conceivably allow the projects to deteriorate without losing tenants. In addition, without additional subsidies, project owners have little economic incentive to keep the project low-income after the compliance period elapses. Finally, households substantially below the poverty level are unlikely to benefit from the credit. Units that rent for 30 percent of poverty-level income are generally beyond the reach of households whose incomes are at half or less of poverty-level income. For example, if area median income is $25,000, projects that have at least 40 percent low-income units have an income limit of $15,000 (60 percent of area median) and qualifying rent of $4,500 per year (or $375 per month). A household with annual income of $8,000 per year (approximately one full time wage at $4.00 per hour or $667 per month) would not generally be able to afford this rent. Vouchers may make these units more accessible to very poor people.

Finally, another source of inefficiency is that the low-income housing credit may not result in housing of a quality or location that is appropriate for or desired by low-income renters. Thus, even if the full value of the credit were passed along to low-income tenants, the value to the renter would be less than the amount of the subsidy. For example, the assisted housing may not be located near jobs or public transportation that the

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2/ Michael P. Murray, "Subsidized and Unsubsidized Housing Starts: 1961-1977," The Review of Economics and Statistics, 65:4, (November 1983), pp. 590-597.

3/ Congressional Budget Office, Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives, 1977.

poor household needs. Moreover, since common facilities such as swimming pools and parking lots are allocated proportionately between low-income and market units for purposes of the credit, investors in mixed-use projects may have an incentive to provide more amenities than low-income households would prefer. The effect is that some low-income households may be nearly indifferent between the subsidized housing and other market rentals that are available in more convenient locations or have fewer unnecessary amenities. Thus, the incentive distorts the choice of housing of the low-income renters and provides less value to the subsidized renter than the cost of the subsidy.

The Administration has addressed many of these concerns by reemphasizing its commitment to rental housing vouchers in the 1989 budget. Vouchers avoid many of the inefficiencies discussed above. The budget proposes to provide 135,500 additional vouchers to needy households. We need to determine whether the low-income housing credit can be as cost-effective and as efficient as vouchers.

We are particularly concerned that the low-income housing credit not become the dominant mechanism for assisting low-income housing. While the current revenue cost of the low-income housing tax credit is estimated to be $60 million in calendar year 1987, the cost grows to around $800 million in fiscal year 1991 as a result of increased usage of the credit and the payment of credits for 10 years on earlier projects. The annual cost of the credits could be $3 billion if fully phased in on a permanent basis. In light of the relative efficiency of vouchers, we question whether so much of housing assistance for the poor should be channeled through the tax credit mechanism.

E. Technical Issues

Many technical issues are addressed in the proposed technical corrections bills. The Treasury Department has testified previously in favor of a technical correction to the 10-year holding period requirement in the limited circumstance in which federally-assisted and federally-insured low-income buildings would otherwise be converted to serve non-low-income tenants. This limited waiver authority is fully consistent with the intent of the waiver provision to reduce the Federal Government's financial exposure with respect to federally-assisted buildings and to prevent conversion of existing HUD and FmHA properties into non-low-income housing. Allowing a waiver of the 10-year holding period requirement provides an incentive to taxpayers to acquire, operate, and maintain existing federally-assisted buildings for low-income tenants, thereby eliminating any risk of foreclosure or conversion. Thus, this waiver authority furthers existing Federal low-income housing programs by protecting Federal financial commitments and preserving the stock of federally-assisted low-income buildings.

The Treasury Department currently is studying the numerous technical corrections to the credit proposed by the House and the Senate. Since it would not be practical to describe or discuss each of the bill's many provisions relating to the tax credit in this testimony, we will provide our views when the technical corrections bill is being considered by Congress.

Other technical issues with respect to the credit have been addressed in regulation projects. To date, the Internal Revenue Service has issued two sets of regulations under section 42, and a third set of regulations will be issued in the near future. The first set of regulations provides guidance to State housing agencies on the proper method to allocate the credit, and the second set of regulations provides guidance to taxpayers seeking a waiver of the 10-year holding period requirement. The next set of regulations will address, among other issues, the extremely complex recapture and partnership rules.

The Internal Revenue Service has tried to develop workable and understandable regulations to address technical issues in the statute. For example, to facilitate use of the credit, the regulations under section 42 have adopted HUD definitions and standards, whenever possible. In addition, to ease administrative burdens, the Internal Revenue Service is considering adopting automatic election procedures such as an automatic election to waive the 10-year holding period requirement, where applicable.

Passage of a technical correction bill and issuance of a complete set of regulations under section 42 are important steps to spur additional use of the credit. We are committed to providing needed guidance to taxpayers as soon as possible.

III. H.R. 3663

H.R. 3663 is designed primarily to encourage the preservation of existing government-assisted multi-family low- and moderate-income housing through additional tax incentives for the owners of the housing. Section 2 of the bill would allow a duplication of depreciation deductions, exclusion of certain gains, as well as low-income housing tax credits to certain owners of low-income housing if they agree to maintain their property as low-income housing for an additional 20 years. Section 3 of the bill would waive the 10-year holding period requirement for the low-income housing credit for all government-assisted buildings which appear likely to stop renting to low- and moderate-income tenants. Section 4 of the bill would allow a seller of certain low-income buildings to exclude from taxable income the gain attributable to indebtedness on the property if the buyer agrees to maintain the building as low- or moderate-income housing for 15 years from the date of sale. Section 5 of the bill would allow certain co-ops to derive more than 20 percent of their income from non-member sources. Section 6 of the bill would provide that income attributable to a mandatory reserve of a housing cooperative would be treated as derived from members for purposes of section 277.

The tax incentives provided by H.R. 3663 are intended primarily to address the loss of low-income housing that may occur when government-assisted projects become eligible to prepay their mortgages and terminate low-income occupancy. Under section 221(d)(3) and 236 of the National Housing Act of 1934, HUD provided interest reduction payments for the construction and substantial rehabilitation of low-income housing projects. Over 5,000 low-income housing projects (containing approximately 600,000 units) were federally assisted under these programs, most of which were completed in the late 1960s and early 1970s. Under these programs, many owners are entitled to prepay their mortgages after 20 years without HUD approval and, upon prepayment, would no longer be obligated to provide low-income housing. Many of the existing HUD-assisted projects are nearing the end of the 20-year obligation period. Without additional incentives, owners of low- and moderate-income housing developments may exercise the provisions allowing them to prepay their debt and thus free themselves of the restriction requiring them to rent to low- and moderate-income tenants.

A. General Comments

We welcome this opportunity to discuss measures to encourage the preservation of housing for low- and moderate-income tenants. This Administration is committed to preserving existing HUD-assisted housing for low-income tenants to the maximum extent practicable and at a cost commensurate with the amount of housing provided. For this reason, the Administration has supported two recent provisions specifically designed to encourage project owners to retain units in low-income occupancy. The Housing and Community Development Act of 1987 recently signed into law by the President contains numerous non-tax incentives for owners who may prepay and convert the housing to market-rate rent occupancy. In addition, a technical correction to the low-income housing tax credit, supported by the Treasury Department, would waive the 10-year holding period requirement for existing federally-assisted housing in circumstances in which federally-assisted and federally-insured low-income buildings would otherwise be converted to serve non-low-income tenants. This correction would provide purchasers with an incentive to preserve rental units in low-income occupancy.

These provisions are part of a new unified housing policy employing existing tools to address the prepayment situation. Both provisions are narrowly targeted to provide benefits only to owners of low-income housing who are capable of prepaying and converting to market-rate occupancy. In addition, HUD, FmHA, and the Treasury will coordinate these provisions, while owners will assess their eligibility for these benefits. Although we support present measures to preserve existing low-income housing, we believe that the current budget situation and the new housing law and tax credit waiver provision provide an opportunity to reassess the proper mix of housing programs and tax incentives to preserve low-income housing. For these reasons, we are opposed to the substantive changes in the tax law in H.R. 3663 that provide additional incentives to owners of low-income housing.

In addition to our general concerns, we have a number of specific comments about each section of the bill. We are especially concerned with windfalls that might inure to the benefit of owners, rather than low-income tenants, under this bill. I will discuss each section of the bill separately.

B. Section 2: Restoration of Basis

Section 2 of the bill would amend the Code to provide a new section 1061 which would allow certain owners of low-income housing to increase their basis in the housing by the original cost of the housing and the cost of any improvements to the housing, if they agree to continue to operate the housing under the existing government program restrictions for at least 20 years. This section would effectively increase the amount of depreciation deductions and limit gain on disposition of the building. The provision also would eliminate the acquisition requirement for the low-income housing tax credit, providing both the credit and the restoration of basis to taxpayers who have owned projects for at least 10 years. If the owner failed to provide the required low-income housing throughout the 20 years, the owner would be subject to a recapture tax equal to the amount of taxes saved in prior years, with interest.

We strongly object to provisions to restore basis. The cost of both the project and the improvements presumably already have been capitalized and depreciated under section 167 or section 168 of the Code. Thus, the effect of this special basis provision may permit a double deduction of the cost of the housing and improvements. The cost would be taken into account twice for depreciation and gain purposes without any corresponding recapture tax. Such a departure from long established principles of tax law and accounting is not warranted.

Second, we oppose the special treatment accorded owners who do not acquire the project by purchase and currently do not qualify for the low-income tax credit. This acquisition requirement was intended to prevent taxpayers from claiming the new tax credit if they had benefited from the generous tax benefits provided under prior law for low-income housing. Section 2 of the bill would not only negate the present acquisition rule and allow such owners to claim the tax credit, but it also would provide an additional benefit to such owners by restoring the basis of the project. We do not believe that such taxpayers should be accorded a windfall by the enactment of H.R. 3663, a windfall that may provide little benefit to low-income persons.

In addition, many of these owners presumably are not currently entitled to prepay their mortgage and stop providing low-income housing.

Third, the amount of tax benefit from restoration of basis would bear no relation to the amount of low-income housing provided. Such a subsidy would operate in an arbitrary manner, resulting in tax benefits unrelated both to the number of low-income individuals served and the current economic situation of the particular project.

Fourth, and equally troubling, section 2 of the bill suffers from the same shortcomings as the current low-income housing tax credit. Because benefits are available only to owners of government-assisted projects, owners of non-subsidized housing would suffer another competitive disadvantage that may threaten the viability of their projects. Moreover, this provision does not provide any incentive for repairs and maintenance and contains difficult and perhaps unworkable recapture rules. Finally, this provision would skew investment towards the tenants currently targeted by the tax credit at the expense of market-rent and very low-income housing tenants and further restrict a low-income tenant's choice of housing. We question whether additional revenue should be targeted in this way.

C. Section 3: Expansion of the 10-year Holding Period

Section 3 of the bill would amend section 42(d)(6) of the Code to waive the 10-year holding period for purposes of qualifying existing government-assisted rental projects for the low-income housing credit. The 10-year holding period would not apply where a sale would help avoid default or conversion to non-low-income housing or where the building was taken in default by a government agency during the last 10 years. For purposes of section 3, "government-assisted building" means any building which is substantially assisted, financed, or operated under any Federal, State, or local housing program.

Section 3 of the bill goes beyond the intent of the original waiver rule and would reward owners of mismanaged or neglected housing projects by providing a waiver any time a credit would help avoid default or mitigate loss to any government. It would actually provide an incentive for owners to let marginal projects deteriorate rather than attempt to keep them viable. Since the purchasers of troubled projects would be eligible for the credit, they would be willing to pay more than they would in the absence of a credit. With the credit, a purchaser would be willing to pay as much as 30 percent more than the project would be worth otherwise. Thus, the broad waiver authority contemplated in this bill would encourage some owners to let their projects fail in order to receive a windfall. Over time, this could reduce the supply of housing available to low-income households.

The provision would also allow a waiver of the 10-year holding period any time a building is acquired by the taxpayer from any governmental body, including State and local governments. As noted above, the intent of the waiver rule was to protect HUD and Federal mortgage insurance funds from financial risk. This expansion of the waiver provision would result in no corresponding increase in Federal savings.

As noted in Part II of our testimony, we support a more limited waiver rule. We believe that the Treasury Department should retain authority to waive the 10-year holding period requirement to prevent federally-assisted and federally-insured buildings from being converted to serve non-low-income tenants.

D. Section 4: Exclusion of Gain From Disposition of Use-Restricted Qualified Low-Income Housing Project

Under section 4 of the bill, an owner (other than a corporation) of certain government-assisted low-income housing could exclude from gross income an amount equal to the excess of the indebtedness on the property over its adjusted basis if the owner sells to a purchaser who agrees to maintain the housing as low-income for 15 years. The provision does not attempt to distinguish between taxpayers who own financially-distressed projects or projects that may otherwise be converted to non-low-income projects and those who are not in default and have a current agreement with a government agency to maintain the housing as low-income for 15 years or more. In either case, this provision would provide windfalls to sellers often without adding or preserving any additional low-income housing.

The amount of subsidy would depend on the amount of debt on the project, not on the number of low-income families assisted. This provision would reward highly-leveraged and therefore potentially riskier projects.

We also foresee serious difficulties in administering this provision. For example, the provision would not impose a recapture tax if the purchaser failed to maintain the housing as low-income housing for the entire 15-year period.

Further, we believe that this provision has a significant potential for abuse since the amount of the subsidy depends directly on the amount of financing and refinancing. A taxpayer could achieve significant tax savings by refinancing the property to exclude that amount from tax upon the sale of the project. Moreover, since the amount of the exclusion is unrelated to the basis of the project, the value of the tax benefits could exceed the cost of the project if the refinancing exceeds the original cost of the housing.

We believe the narrowly-drawn waiver provision described in Part II of this testimony would accomplish the same goals as this provision in a less costly and more efficient manner. The narrow waiver provision would encourage sales of property to prevent foreclosure or conversion yet would not provide an unnecessary windfall to owners of government-assisted low- and moderate-income housing.

E. Section 5: Waiver of 80-percent Income Requirement under Section 216 For Limited Equity Cooperative Housing Corporations

Section 5 of the bill provides that limited equity cooperative housing corporations are not subject to the requirement that at least 80 percent of more of their income for the taxable year be derived from tenant- stockholders. As a result, limited equity cooperative housing corporations could derive more than 20 percent of their income from non-tenant stockholders and remain eligible to deduct taxes, interest, and business depreciation under section 216 of the Code.

Treasury is opposed to waiving the 20-percent limit for limited equity cooperative housing corporations. If the 20-percent limit is removed, any amount of non-tenant income would potentially be used by cooperatives to provide economic benefits to the tenant-stockholders (generally in the form of reduced rents). Such tenant-stockholders normally do not report taxable dividends in such circumstances. Under corporate tax rules, corporate after-tax income cannot be used to provide benefits without creating taxable dividend income. It would be inappropriate to expand the ability of cooperative housing corporations to earn outside income without subjecting the tenant-stockholders to dividend taxation. At other hearings, Congress itself has expressed concern about the effect on competition of preferences being given to commercial tax-exempt or tax-preferred entities.

F. Section 6: Treatment of Income on Mandatory Reserves of Limited Equity Cooperative Housing Corporation

Section 6 would treat income from mandatory reserves as derived from tenant-stockholders for purposes of section 277 of the Code. Taxpayers could elect to have this provision apply retroactively. Treasury testified in opposition to a similar bill before this Subcommittee in May of 1986. In that testimony, we objected to the provision because it would interfere with ongoing controversies between the Internal Revenue Service and taxpayers. Because section 6 of this bill would also apply retroactively and affect current cases, the Treasury Department must oppose this provision of the bill.

Allowing a cooperative's investment income to be treated as membership income would be roughly equivalent to exempting a cooperative homeowner's investment income from tax. The purpose of section 277 is to prevent membership organizations, such as housing cooperatives, from obtaining such an unintended benefit.

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This concludes my remarks. I will be happy to answer any questions.

Chairman **Rangel**. The next witness is from Housing and Urban Development, C. Duncan MacRae, General Deputy Assistant Secretary for Policy Development and Research.

STATEMENT OF C. DUNCAN MacRAE, GENERAL DEPUTY ASSISTANT SECRETARY FOR POLICY DEVELOPMENT AND RESEARCH, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. **MacRae**. Thank you very much, Mr. Chairman. I am also very pleased to be here with you and to share the thoughts that HUD has regarding the low-income housing tax credit. In my testimony today I will explain why HUD considers this credit to be especially relevant to the Department's mission, and I will discuss two minor but extremely important changes which HUD is seeking through the technical corrections. The basic provisions are designed to make credit work more harmoniously with current housing programs and policies.

I will also briefly review the analysis that HUD has done of the housing credit, and then describe two studies that the Department has planned to evaluate the credit and its success.

First let me talk about the role of the tax credit in housing policy. Throughout this administration it has been HUD's policy to assist as many very low-income families as possible within available resources. I am proud to say that in 1980 we had 3.1 million assisted households, and that number has increased such that in 1988 it is now 4.3 million. That represents an increase of 1.3 million. In fact, in 1989 we project an assistance level of 4.4.

We, of course, support the housing voucher approach, and there is a very good correspondence between housing vouchers and the low-income housing tax credit. Both serve low-income renters; both use the existing housing stock. We estimate that the housing credit could support about 75,000 to about 200,000 low-income housing units per year.

Now, by increasing the availability of housing, the credits complement the voucher and section 8 programs, which, as you know, are designed to basically deal with the issue of affordability. And by increasing the affordability of housing credit units, the housing voucher and section 8 programs increase the accessibility to very low-income families.

The minor changes which I will now discuss will increase the correspondence between the housing credit and these HUD programs to help low-income renters.

The first change is designed to make Federal rental assistance programs work well with the credit. Under the section 8 program, a household must pay 30 percent of its monthly adjusted income for rent. Under the voucher program a household may elect to pay more than 30 percent of its income from rent. Without a technical correction, a section 8 or voucher household whose rent payment rose above the housing credits rent cap, which is simply either 30 percent of 50 percent or 30 percent of 60 percent of median gross income, depending upon how the unit was qualified, could not be counted by an owner as occupying a unit eligible for the housing credit.

So our basic desire here is that as long as the unit is eligible for owner section 8 and voucher assistance, we feel that it ought to be eligible for the credit assistance.

In the technical corrections bills introduced in the House and in the Senate, all units occupied by households receiving Federal rental assistance payments would be eligible for the credit. With this change, an owner could charge the rent that is permitted under HUD's rental assistance payment program rules and the unit would continue to be eligible for housing credits. The household would continue to participate in our assisted housing programs until 30 percent of its income equals the unit's gross rent in the case of the section 8, or the payment standard in the case of vouchers.

This technical correction would greatly simplify the use of the housing credit with our Department's rental assistance programs.

The second change is designed to assist in dealing with the prepayment problem, which has already been very extensively discussed by the two Senators and will also be discussed in rather full detail by my colleague, Thomas Demery, tomorrow, I believe.

The third criterion for waiver of the 10-year holding period requirement in the original statute, under circumstances of financial distress, was proposed for elimination by the technical correction bills. Rather than eliminating it, we believe that the provision should be modified so that it can allow for the extension of the waiver authority to deal with prepayment. In fact, in testimony by former Assistant Secretary Chapoton of Treasury before the Senate Finance Committee, he indicated that the Treasury Department sought to retain authority to waive this 10-year holding period requirement when such a waiver is necessary to prevent federally assisted and federally insured low-income buildings from being converted to serve non-low-income tenants. Specifically, we support the language in the miscellaneous tax provisions of the House omnibus reconciliation bill that would have permitted waivers to be granted to section 221(d)(3) and section 236 projects to prevent their conversion to non-low-income use.

Let me now turn, if I may, to analysis of the low-income housing tax credit. HUD staff has analyzed the potential impacts of the low-income housing tax credit on low-income housing. The basic question has been: What rent would a unit have to receive in order to earn an acceptable rate of return for its owner?

We essentially have come to the conclusion that the credit works under three basic conditions, and if one or more of these conditions is not satisfied, then the credit may not be sufficient to provide the benefits necessary to induce developers and investors in low-income housing. What are these three conditions?

The first condition is that the area is not one of high construction costs and low median income. The second one is that there are no abnormally high risks associated with the project. And the third one is that the passive loss limitations are not binding.

What do these mean? First, a situation in which you have an area which is one of high construction costs and low median income would be a situation where the credit would not be sufficient to induce new construction or rehabilitation. The low median income would mean that the rent cap potentially would be too low.

The condition of abnormally high risk would mean that the developer/investor would have a very high discount rate, an abnormally high discount rate, perhaps caused by conditions of uncertainty with respect to the economic situation or, uncertainty with respect to tax provisions.

The third condition is the one of a binding passive loss constraint. If it is not possible for individuals to use the exemptions that are provided under current law, or if corporations, who are not basically subject to the passive loss constraint, with certain exceptions, do not use the credit, then it is difficult to use the benefits that underlie the credit. It is too early, in our mind, however, to tell whether these three conditions are in effect. And that's why we are carrying out two studies.

The first study is designed to actually track the use of the low-income housing credit during its first two years. We are already gathering data with assistance from the Urban Institute and the National Council of State Housing Agencies. We are ascertaining what uses of the credit occurred in 1987, and then we are going to be monitoring in the middle of 1988 and toward the end of 1988 the use of the credit in 1988.

So we will have another survey in the middle of the year and then one in January 1989. We will be pleased, of course, to share the results of this analysis with you.

The second HUD study will be a more formal process and outcomes evaluation, and is designed to provide information on the type of housing provided and households assisted during the first two years of the low-income housing credit. It will also examine the impact of the credit on the financial soundness of the project and ownership arrangements.

All the information gathered in this study we are hoping would be available next spring, and, of course, we will be very pleased to share this information with you.

There is a more extensive discussion of the evaluation in my prepared testimony, and so let me just conclude my remarks here.

Thank you.

[The statement of Mr. MacRae follows:]

March 2, 1988

TESTIMONY ON THE LOW INCOME HOUSING CREDIT

before

The Subcommittee on Select Revenue Measures

of the

COMMITTEE ON WAYS AND MEANS

by

C. Duncan MacRae

General Deputy Assistant Secretary
for Policy Development and Research
U.S. Department of Housing and Urban Development

Thank you for the opportunity to testify before this committee on a matter of great importance to the Department of Housing and Urban Development.

In my testimony today, I will explain why HUD considers the low income housing credit to be especially relevant to the Department's mission. Then I will discuss two minor but important changes which the Administration is seeking to enable the housing credit to work more harmoniously with current housing policies and programs. My testimony will also review HUD's analysis of the housing credit and describe two studies the Department is undertaking to better assess how well the credit is working.

THE ROLE OF THE HOUSING CREDIT IN HOUSING POLICY

Historically the tax system has provided substantial incentives for investment in rental and owner-occupied housing. Therefore, as the legislative process which led up to the Tax Reform Act of 1986 began to change some of the key tax rules applied to residential investment, HUD followed these developments very closely to discern their likely impact on housing. Secretary Pierce set the Department's primary goal as ensuring that the needs of low income renters would be adequately provided for.

It is for this reason that when Congress added the low-income housing credit to the Tax Reform Act of 1986, specifically to support low income housing, HUD and the Administration recognized the value of this provision. We worked closely with Congress to refine this approach so that it has the potential to be a cost effective means of supplying affordable rental housing to meet the shelter needs of our nation's poor.

The resulting provision directly corresponds to the policy of this Administration --

> to assist as many low income families within available resources and focus on assisting those families with the most severe needs.

Throughout this Administration, these objectives have been supported by using other cost effective approaches, such as the Housing Voucher program, to increase the number of low income families assisted.

There is a good correspondence between the low income credit and the Administration's Housing Voucher program. Like Housing Vouchers and other federally assisted housing, the low income housing credit is specifically designed to serve low income renters with incomes less than either 50 or 60 percent of median family income. Consistent with housing policy, the housing credit recognizes the importance of preserving the existing stock of housing by providing for both acquisition and rehabilitation of housing for low income families. Currently discussions of housing policy are exploring the role that State governments should play in providing for the housing needs of low income families. Under the procedures of the low income housing credit, States determine which projects will receive the credit and have broad powers in designing and implementing this allocation process.

The housing credit could be a major new source of housing for low income families. Depending upon demand by owners and developers and upon how States choose to allocate the credits between new construction, rehabilitation, or acquisition, the housing credit could support 75,000 to 200,000 low income housing units per year. This availability of additional housing choices complements the Housing Voucher and Section 8 programs which make it possible for low income families to afford decent housing. The existence of these units increases the choices available to these program participants. Historically, tax benefits have been a major incentive for making more low income housing available. The low income housing credit continues that traditional role but with clear emphasis on low income housing.

The ability of housing vouchers to deal with the limited purchasing power of low income families, the affordability problem, also provides an important complement to the housing credit. Housing Voucher and Section 8 recipients can occupy tax credit units. The support provided by these programs can help very low income families, those with incomes substantially below 50 percent of median income, to afford the restricted rents in housing credit units.

In addition to its use with housing vouchers and Section 8 certificates, the credit could also be used to avert prepayment or defaults on HUD assisted low income housing projects. The waiver provision specifically recognizes the use of the credit to protect HUD's mortgage insurance funds.

Let me note, however, before discussing possible minor changes to the waiver provision, that the President's 1989 Budget provides direct on-budget assistance tools, namely vouchers and Section 8 certificates, for ongoing rent subsidies to low-income families in FHA-insured projects. More specifically, a substantial amount of such assistance is proposed in the President's 1989 Budget for households living in projects which (1) prepay their mortgages; (2) default on their loans and go into assignment or foreclosure; or (3) are sold or otherwise disposed of. The Congress has supported these forms of assistance in the past to deal directly with any tenants in danger of losing their Federal rental assistance.

The minor changes which I will now discuss will increase the correspondence between the housing credit and these HUD programs to help low income renters.

CHANGES FOR CONSIDERATION AS TECHNICAL CORRECTIONS TO THE LOW INCOME HOUSING CREDIT

Since the passage of the Tax Reform Act of 1986, the Administration has been working closely with Congressional staff on technical corrections and regulations. Two technical corrections were proposed by the Administration. One, removing a conflict between Section 8 and tax credit rules, was incorporated into the technical corrections bills introduced in the House and Senate in the last session. The other, extending eligibility for a waiver under Section 42(d)(6) to projects eligible to prepay their mortgages, was supported by O. Donaldson Chapoton, Treasury Deputy Assistant Secretary for Tax Policy, in testimony July 22, 1987, before the Senate Finance Subcommittee on Taxation and Debt Management and was included among the miscellaneous tax provisions in the House Omnibus Reconciliation bill. I would like to discuss both of these proposals briefly since they have not yet been enacted into law.

Federal Rental Assistance Programs and the Tax Credit

Under the low-income housing credit as enacted by the Tax Reform Act of 1986, to qualify for housing credits, a unit must be occupied by a household with income below either 50 percent or 60 percent of area median income (depending upon the targeting option selected by the owner) [Section 42(g)]. Following initial occupancy, a household's income may increase to 140 percent of the qualifying income before its unit ceases to qualify for housing credits. The unit must also be rent-restricted: its rent must not exceed 30 percent of the qualifying income. Section 8 and comparable rental assistance payments are excluded from gross rent in determining whether a unit meets the rent-restriction test; only the household's contribution to rent counts in determining a unit's eligibility for housing credits.

Under the Section 8 program, a household must pay 30 percent of its monthly adjusted income for rent (or alternatively, 10 percent of its unadjusted income or the monthly portion of a welfare assistance payment designated for rent). Under the voucher program, a household may elect to pay more than 30 percent of its income for rent. These program features can conflict with housing credit rules in the manner described below.

Without a technical correction, a Section 8 or voucher household whose required contribution to rent under the rules of these programs rose above the restricted rent cap could not be counted by an owner as occupying a unit eligible for the housing credits. This problem could not arise for a Section 8 certificate holder at the time of initial occupancy, because the household's income must be below 50 percent of area median income to qualify for rental assistance. However, as the household's income rises, its required contribution to rent could exceed 30 percent of the housing credit qualifying income, so that its unit could not be counted by the owner for housing credits.

The problem of the household's contribution to rent exceeding 30 percent of the housing credit qualifying income could arise for a voucher household even at the time of initial occupancy. In the voucher program there is no rent ceiling and the household can choose to contribute more than 30 percent of its income to rent. This problem could curtail the choice of units available to voucher households. Even if the problem did not arise at the time of initial occupancy, it could arise as the voucher household's income increased, and its contribution to rent exceeded 30 percent of the qualifying income.

Recognizing this problem, the Administration prepared an analysis and recommendations for change which it discussed with Congressional staff. In the technical corrections bill introduced in the House and Senate, all units occupied by households receiving Federal rental assistance payments would be eligible for housing credits former S. 1350, Section 102(1)(11)]. With this change, an owner could charge the rent that is permitted under HUD's rental assistance payment program rules, and the unit would continue to be eligible for housing credits. The household would continue to participate in our assisted housing programs until 30 percent of its income equals the unit's gross rent (or the payment standard in the case of the voucher program). This technical correction would greatly simplify use of the housing credit with the Department's rental assistance programs.

This technical correction would also enhance the ability of housing credits to assist low-income households. Housing credits increase the availability of low-income housing by replacing the tax incentives formerly provided to low-income rental housing, but they do not assure that this housing is affordable by these households. Many low-income households have income far below 50 percent of area median income. For example, a household with 30 percent of area median income would have to pay 50 percent of its income for a unit renting for 30 percent of 50 percent of area median income and would have even more difficulty affording rents keyed to 60 percent of area median income. Used together, housing credits and Section 8 or vouchers address both availability and affordability problems, enhancing the effectiveness of both.

Waiver for Projects Eligible to Prepay Their Mortgages

The second criterion for a waiver, "under other circumstances of financial distress," was proposed for elimination by the Technical Corrections Act of 1987 [Section 102(1)(7)]. The Administration opposed the total deletion of authority to waive the 10-year holding period requirement in circumstances other than those that involve the potential assignment of a mortgage to a Federal agency or a claim against a Federal mortgage insurance fund. Treasury Assistant Secretary Chapoton testified on July 22, 1987, that the Treasury Department should retain authority to waive the 10-year holding period requirement in the limited circumstances when such a waiver is necessary to prevent federally assisted and federally insured low-income buildings from being converted to serve nonlow-income tenants. Specifically, we support the language in the miscellaneous tax provisions of the House Omnibus Reconciliation Bill which would have permitted waivers to be granted to Section 221(d)(3) and Section 236 projects to prevent their conversion to nonlow-income use. The Administration would, of course, support similar treatment for FmHA Section 515 projects likely to prepay.

The Administration believes that such a waiver criterion is needed to support current housing programs and to reduce financial loss to the Federal Government that occurs under certain circumstances when HUD-assisted projects become eligible to prepay their mortgages and terminate low-income occupancy.

Under HUD's Section 221(d)(3) and Section 236 assisted housing programs, the Federal Government provided interest reduction payments for the construction and substantial rehabilitation of low-income housing projects--a one-time interest rate buydown to three percent in the case of the Section 221(d)(3) program authorized in 1961, and monthly payments to mortgagees to reduce the mortgagor's interest rate to one percent in the case of the Section 236 program authorized in 1968. Over 5,000 low-income housing projects with about 600,000 units were federally financed or insured under these programs, the bulk of which were completed in the late 1960s and early 1970s.

Under these programs, limited dividend owners (but not nonprofit owners) are entitled to prepay their mortgages after 20 years without HUD approval and are no longer obligated to provide housing to low-income households. Two types of limited dividend projects are not entitled to prepay after 20 years without HUD approval. Financially troubled projects that have received flexible subsidy payments are required to observe low-income occupancy requirements for at least the remaining term of the mortgage, even if the mortgage is prepaid. And projects receiving rent supplements or rental assistance payments are also ineligible to prepay. Section 101 rent supplement payments and Section 236 rental assistance payments (RAP) are forms of rental assistance payments similar to Section 8 under which HUD pays a portion of the rent for qualified low-income households. The term of the rent supplement or RAP contract between HUD and a project owner was generally the term of the mortgage which had a maximum of 40 years. However, conversion of many rent supplement and RAP contracts to Section 8 contracts had the effect of restoring the mortgage limit to 20 years. In most instances, an owner can opt out of a Section 8 contract at 5 year intervals, and the termination date for such a contract is independent of the prepayment moratorium.

Providing a waiver in these circumstances would preserve the supply of low-income housing that was provided at substantial Federal expense and could obviate the need for costly new financial incentives to owners or even more costly new construction programs. As you know, this is a matter of considerable recent concern to both HUD and the Congress. My colleague, Tom Demery, the Assistant Secretary for Housing and Federal Housing Administrator, will discuss this problem in detail tomorrow.

Various incentives are being considered by HUD, the Congress, and housing experts to encourage project owners who might prepay to retain units in low-income occupancy. The low-income housing credit should be one of these incentives. It is projects that are marginally capable of prepaying and converting to market-rate occupancy that should be eligible for a waiver from the 10-year placed-in-service rule, since purchasers of such projects may find that housing credits provide sufficient incentive to preserve rental units in low-income occupancy and so deter more costly options for meeting low-income housing needs.

Therefore, we recommend that the Secretary of the Treasury have the authority to grant a waiver to a Section 221(d)(3) or Section 236 project that the Secretary of HUD has determined: (1) is eligible to prepay its mortgage, (2) has been placed-in-service in the last 10 years, and (3) could charge market rents and, thus, would prepay. Furthermore, the Secretary of HUD should include an estimate of the amount of credit necessary to avoid conversion. The waiver would be granted only to those project owners who elect not to prepay their Section 221(d)(3) or Section 236 mortgage, and so remain subject to HUD's regulatory oversight.

If a waiver is granted in conformance with this process, receipt of low-income housing credits would preserve the rental units that were built with substantial Federal outlays in low-income occupancy in markets where low-income housing is needed.

HUD ANALYSIS OF THE LOW INCOME HOUSING CREDIT

HUD staff has analyzed the potential impacts of the low income housing credit on low income housing. In these analyzes we have simulated the cash flow of a project, including the cash received upon sale of a project, to determine whether or not investment in a project would be profitable. By approaching the question in this manner, we can determine under what conditions, including various tax treatments, a project would be a good investment. The basic question has been what rent would a unit have to receive in order to earn an acceptable rate of return for its owner. In particular, are the rents necessary to make the project a good investment less than the rents allowed by the housing credit.

The analysis is quite flexible. For example, we have simulated projects that cost $30,000 per unit to build all the way to projects that cost as much as $100,000 per unit to build. We have varied the rate of return on the investment of the developer from a real rate of 6 per cent to a real rate of 18 per cent. We have compared projects using no housing credit, the 70 percent credit, the 30 percent credit, various combinations of the two credits, and the credit with tax exempt financing.

Our analysis finds, not surprisingly, that under certain conditions the housing credit provides sufficient incentives to make the building of low income housing profitable while under other circumstances the housing credit is insufficient to do so. The analysis provides insights into the conditions which favor or oppose successful use of the housing credit.

For example, under the assumptions that:

> the area is not one of high construction costs and low median income,
>
> there are no abnormally high risks associated with the project and,
>
> the passive loss limitations are not binding,

our analyses of the impact of the low income housing credit on prototypical low income housing projects show that the credit is sufficiently generous to provide investors with a healthy rate of return. Investment in low income housing will be encouraged.

If the above assumptions are not satisfied, the credit may not be sufficient to make an otherwise unprofitable low income housing project profitable for investors. If construction costs are relatively high and median incomes are relatively low, the restricted rents will often not be sufficient to provide a reasonable profit even when coupled with the benefits of the credit for new construction. For areas with these two characteristics, the credit may still be useful for both acquisition and rehabilitation of low income housing. It will not however, provide sufficient incentives to encourage new construction.

If there are abnormally high risks associated with a project, it may be unworkable even with the benefits of the housing credit. To cover the additional risks, investors would require a higher rate of return than could be provided with the housing credit. These higher than normal risks may be the result of any number of factors ranging from uncertainty over the regulations governing the housing credit program all the way to reluctance to believe that Congress will not change the rules in the future to make the credit much less valuable. Under these circumstances, the housing credit may not provide sufficient returns to cover the higher risks to make the project attractive to investors.

Finally, if the passive loss limitation is fully binding -- in the sense that investors cannot use housing credits in the year that they are *earned, the rents needed to provide a reasonable rate of return on* investment may be higher than the restricted rents allowed in the law. While this restriction may be severe in the case of individuals or partnerships, it does not apply to corporate investors. Corporations are not subject to passive loss limitations. As a consequence, low income housing may now be a particularly value investment for corporations. We are eager to see how quickly and how extensively corporations move into investing in rental properties. While a significant level of corporate investment may eventually occur, what may be needed in the short run is simply to educate corporations on the benefits of the housing credit to them.

These analyses indicate that the low income housing credit has the potential to be a powerful incentive to provide low income housing, but there are conditions under which it will not provide a sufficient stimulus. We do not know the full extent of these unfavorable conditions. We also know there will be a learning curve and that utilization of the housing will be initially low under even favorable circumstances. How much utilization will occur as time goes on is an empirical question. For this reason HUD is initiating two major studies of the low income housing credit.

HUD MONITORING OF THE LOW INCOME HOUSING CREDIT

The Department of Housing and Urban Development has initiated a set of studies to assess the early experience with the low income housing credit. As noted earlier, HUD recognizes the importance of the housing credit both to national housing policy in general and to the specific programs which HUD administers. For this reason, HUD believes that the Executive Branch and Congress need to know how well the housing credit is achieving its intended objectives, what modifications, if any, might make the housing credit more effective, and whether the housing credit deserves to be extended as a significant Federal effort to provide for the housing needs of low income families.

In addition to the in-house modeling which I have just discussed, HUD's evaluation efforts consist of two related studies, one on-going and one in the process of being awarded.

The on-going study will track the utilization of the low income housing credit during its first two years to provide a general picture of how widely the housing credit is being used and for what type of projects. For this purpose, HUD has entered into a contract with the Urban Institute and its subcontractor, the National Council of State Housing Agencies, to collect utilization data from the State agencies administering the housing credit. The basic data shall include a few key items for all projects requesting housing credit allocations -- items, such as, size and location of project, type of credit (new construction, substantial rehabilitation, or acquisition of existing units), amount of credit, income election and set-aside percentages, rents, type of financing, and the use of other Federal and State or local subsidies. This data compilation effort will also involve assembling all of the State rules and procedures with updates prepared in conjunction with their responsibilities as the housing credit allocation mechanism.

The Urban Institute and the National Council of State Housing Agencies will conduct this survey three times in the next year. The first survey, currently underway, collects information on all requests for housing credits received by each of the 50 States in 1987. HUD anticipates having a summary report available in June which we will be pleased to share with the Congress. The second survey will occur in July 1988 and will cover all State activity for the first six months of 1988. The third survey will occur in January 1989 and will cover all activity for remainder of 1988. Final reports from these surveys are expected in December 1988 and March 1989 respectively. Again we will pleased to share these findings with the Congress.

The National Council of State Housing Agencies has played an invaluable role in assisting HUD with this data collection effort by convincing all State credit agencies to participate. Through its efforts, States are collecting more data than they might otherwise than done on their own, and they are doing so using a uniform format that makes the data collection both efficient and useful for program evaluation.

The second HUD study will be a formal process and outcomes evaluation. The Department has planned the study recognizing that the Administration and the Congress will have to decide in 1989 whether to continue the low income housing credit beyond its initial three year authorization and, if so, what modifications might be desirable.

This study will attempt to answer a number of questions relevant to the reauthorization discussion. First, it will provide the best information possible on the type of housing provided and households assisted during the first two years of the low income housing credit. An in-depth survey of 200 to 300 approved projects will gather data on the actual or projected characteristics of residents of housing credit units, including income, race, and elderly or family status. The survey will also report on the physical characteristics of the units supported by the credit. For new construction, this will include information on the size, location, level of amenities, and competitiveness within the local housing market of the projects. For rehabilitation, the data will cover the nature and extent of the repairs and their impact on the project. For acquisition, the survey will describe the type of projects being acquired, the nature and extent of any accompanying rehabilitation, and the impact of the acquisition on the residents. For all projects in the sample, the survey will examine the impact of the credit on the financial soundness of the project and how various ownership arrangements can take advantage of the housing credit. An important issue is the extent to which the low-income housing credit was essential for the constriction, rehabilitation, or acquisition of these properties. Another important issue is whether, as used, the credit is less expensive than other means of producing the same housing benefits. Positive impacts of these projects on their neighborhoods will be examined.

In addition to the sample of 200-300 project, this study will include a sample of 15 to 20 States to provide information on the administrative issues associated with the credit. The survey will ask State officials and other persons concerned will the housing credit about their experiences in the first two years to identify the particular strengths and weaknesses of the approach taken in the legislation to allocate the limited credits allowed. This State survey will also focus on the use of the housing credit with tax exempt financing.

Both the survey of States and the survey of projects will pay particular attention to the use of the credit with HUD low income assistance programs. This will include analysis of the use of housing vouchers and Section 8 certificates by residents of housing credit units. It will also include an examination of the use of the credit for acquisition of older HUD assisted projects, especially those HUD has classified as "troubled".

HUD plans to award a research contract to conduct these surveys. The necessary "Request for Proposals" has been prepared and will be issued shortly. HUD anticipates preliminary results will be available next Spring in time for consideration during any discussion of reauthorization. HUD looks forward to sharing this important information with the Congress.

As I have emphasized throughout this testimony, HUD believes that the low income housing credit is an important element in the Nation's housing policy. Rational development of housing policy requires reliable information on the impact of this legislation. These studies represent a serious and timely effort to provide that information.

CONCLUSION

On the basis of my testimony I would like to place three conclusions before this Committee.

1. There is a good correspondence between low income housing credit and national housing policy because it targets its benefits on the low income population, those with incomes less than 50 or 60

percent of median income; it recognizes the importance of preserving the existing stock of housing; and it can be used in conjunction with current Federal housing programs.

2. Analysis by HUD indicates that credit can provide a powerful incentive to provide low income housing but that there are conditions under which it will not provide a sufficient stimulus. We know there will be a learning curve and that utilization of the housing credit will be initially low under even favorable circumstances. How much utilization will occur as time goes on is an empirical question. For this reason HUD is initiating two major studies of the low income housing credit.

3. While the low income housing credit generally fits well with HUD programs, there are two minor changes needed to make it fully consistent with and supportive of current housing policies and programs. These changes are:

   - Eliminate any inconsistency in rules between the credit and Section 8 and housing voucher programs. The Technical Corrections Bill passed last year by both the Senate and the House contained a provision which would achieve this result.

   - Make the waiver available at the recommendation of HUD for projects which are eligible to prepay their mortgages and terminate participation in HUD's assisted housing programs. The provision was included among the miscellaneous tax provisions included in the House Omnibus Reconciliation bill.

Chairman RANGEL. Thank you. Mr. Clark, Administrator, Farmers Home Administration.

STATEMENT OF VANCE L. CLARK, ADMINISTRATOR, FARMERS HOME ADMINISTRATION, U.S. DEPARTMENT OF AGRICULTURE

Mr. CLARK. Thank you, Mr. Chairman. I welcome also this opportunity to appear before your subcommittee and to share with this committee the experience of the Farmers Home Administration in dealing with the problem that you in Congress have wrestled with several times in recent years—how to reserve the stock of federally assisted housing for low-income tenants when it would be more profitable for the owners to convert that property to higher cost rental units or condominiums.

Tax incentives, of course, are important to what we deliver in the field, our housing programs to rural Americans. Of course, tax incentives are under the exclusive jurisdiction of the Committee on Ways and Means, and I am pleased that your letter of invitation also requested discussion of the recently enacted housing bill as well.

This new legislation, plus some longstanding authorities in existing statutes, and a proposal for rural housing vouchers in the President's 1989 budget does present, I think, to you a picture of the tools that we at Farmers Home Administration work with. I am pleased that the Treasury representative has already presented the administration views on H.R. 3663.

As you well know, Mr. Chairman, the FmHA of the Agricultural Department is the credit agency for agriculture and for rural development, providing direct and guaranteed loans for farm ownership and production, for rural housing, for community facilities such as water and waste programs, and for business and industry. Our housing programs include loans for ownership of single-family homes as well as for rural rental housing.

Our rural rental housing program is carried out under the authority of the Housing Act of 1949, section 515. And perhaps you will recall that we make loans for 97 percent of the development costs of projects and those projects are amortized over a 50-year period. Rents are based on operating and maintenance costs, and amortized payments. The note rate for our section 515 loans is currently 9.5 percent, and traditionally our agency has had two programs that allow us to reduce rents in a manner similar to HUD section 8, one of them being the interest credit program, which reduces the interest rate paid by a borrower to as low as 1 percent, so as to reduce rents to 30 percent of the tenant's income—that benefit, of course, is passed on to the tenant. This has been a primary method of matching rents with very low and low-income tenants intended to benefit from our program. Two, the rental assistance program, a further subsidy allowing us to reach even lower income tenants who cannot afford to pay the minimum rent made possible with interest credit assistance.

By the end of fiscal year 1987 over 14,000 rural rental housing projects, accounting for some 350,000-plus individual living units, had been financed under the section 515 program. When that program was instituted back in the early sixties, I believe, there was no restriction on the prepayment of these loans. Many of the borrowers were local people and small contractors who got into our program to build units and generate an investment cash flow. In the mid-1970's, however, the type of borrower began to change. Syndications of limited partnerships began to get into the program to take advantage of the tax laws. These were primarily in the form of accelerated depreciation. The benefits of these incentives were generally depleted within 7 to 10 years, after which borrowers could find it financially advantageous to sell their projects.

In 1979 it became evident in some cases tenants were being displaced from section 515 projects in sections of the country where high growth rates were stimulating demands for housing. In response, the Congress amended the law to require that new section 515 borrowers be obligated to maintain the use of the projects for low- and moderate-income tenants for a period of 15 to 20 years, depending on the type of loan. Since this applied only to new loans, borrowers whose loans were made earlier remained free to prepay. As a result, displacements continued to be a problem.

Nationwide approximately half of the projects and almost half the units out there were financed prior to the requirement, and thus are not covered by use restrictions.

Prior to fiscal 1987 there was a strong demand for section 515 loans by limited partnerships which then syndicated the projects at a value of approximately 25 percent of the loan amount. Projects did not need to have rental assistance associated with them in order to be attractive to investors, although both interest credit and rental assistance were indeed factors in the location of the projects.

The Tax Reform Act of 1986 eliminated, as you know, accelerated depreciation tax benefits and replaced them with a tax credit.

During most of fiscal 1987 we saw a dramatic decrease in investor interest in the section 515 program. We attributed this decline to the act. Then something happened and things began to change. We believe that investors found that alternatives to housing investments were not as attractive as they might have first appeared. In addition, the Congress shifted some $115 million in section 515 loan funds to the rental assistance program, which led to creation of some 10,000 rental assistance units. The resulting combination appears to have rekindled investor interest and syndication has again picked up. However, the benefits are now being marketed in the range of 16 to 19 percent of the loan amount. The success of the section 515 rural rental housing program in providing housing for very low and low-income tenants appears to be dependent on investors obtaining the 4-percent tax credit and being able to assure a high percentage of very low income tenants. Rental assistance enables very low income individuals to afford rental housing in sufficient numbers for owners to qualify for the tax benefits.

One clear indication: Prior to the Congress' action in shifting funds from loans to rental assistance in fiscal 1987, we projected that we would use less than 50 percent of the loan funds. After the shift we had a dramatic increase in demand, resulting in the uses of all the funds. For fiscal year 1988 the Congress also transferred loan funds to rental assistance, and we predict that all of our section 515 loan funds will be utilized.

These changes, however, did not directly address the prepayment/preservation issue, which has been addressed in a different manner to some extent since the 1979 restrictions were enacted. In October of 1986 the Congress placed a moratorium on prepayments to provide time for a solution to be found. This moratorium has been continued repeatedly with only short lapses up to now. Meanwhile, Farmers Home has eased the problem administratively within the constraints in existing law.

As you know, last month the President signed into law new housing legislation which contained language affecting prepayment. The provision imposes prepayment limitations on loans made prior to December 21, 1979. Farmers Home expects to have implementing regulations in effect in April, and under those new regulations, under the new law, if a borrower who is not subject to restrictive use limitations expresses a wish to prepay, Farmers Home will take the following action, one of them being to determine whether the housing is needed for the low-income market in the area in which it's located; we are going to determine whether or not that property is needed, accept prepayment only if the borrower agrees to maintain the housing for the low-income market for the remainder of the 15- or 20-year period based on the date of the loan.

We want to provide incentives to borrowers unwilling to make the commitment which I just mentioned. In exchange for incentives the borrower must agree to maintain the housing for low-income rental purposes for an additional twenty years. Those incentives would include interest subsidy, if none is currently available on the project; additional rental assistance for the project; an increase in the allowable return on investment from the current 8 percent to 10 percent; a loan for equity of up to 90 percent of the value of the project can be granted to the borrower or anyone who purchased the project from the borrower, and would have unrestricted use of this equity loan which would be made under the same subsidized conditions as other section 515 loans—and this is most important. Other than tax incentives, we see this as the only incentive which will do the job of inducing borrowers to maintain the housing for low-income people.

If a borrower refused to accept the incentives, he or she would be required to offer for sale the project to an existing non-profit borrower or a public agency at a fair market value. Farmers Home would authorize a transfer of existing loan and loan the full amount of the equity plus the costs to the nonprofit purchaser to accomplish that sale. The nonprofit corporation would have to agree to maintain the project for low-income housing, for the remaining useful life. If no such offer were forthcoming or if the necessary funds were not appropriated, we would have to accept the prepayment. Displacement problems for tenants would occur although they have been reduced somewhat by regulations promulgated by Farmers Home in 1987.

Tenants must now receive a minimum of 6 months' notice under our new regulations, rather than the previously mandated 30-day notice, before they can be displaced.

Displaced tenants now receive priority for units in other FmHA projects nationwide, rather than just locally, and receive this priority for a longer period of time.

We also provide displaced tenants receiving rental assistance with the opportunity to have it transferred to any other FmHA project in which they move. It goes with them.

These options in the new housing act were explicitly made subject to appropriations, and no funds, I would point out, have yet been appropriated to do these things that we have in mind.

Finally, Mr. Chairman, I would note in closing that of the 21,000-plus units assisted by the rural housing voucher program proposed in the President's 1989 budget, 1,200 of those units would be earmarked for families displaced by prepayments in section 515 projects. That I think is the number we estimate that might be affected in prepayments in fiscal 1989.

That, Mr. Chairman, concludes my remarks.

[The statement of Mr. Clark follows:]

STATEMENT OF

VANCE L. CLARK
ADMINISTRATOR
FARMERS HOME ADMINISTRATION

BEFORE THE

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES
MARCH 2, 1988

Mr. Chairman, I welcome the opportunity to share with this Subcommittee the experience of the Farmers Home Administration (FmHA) in dealing with a problem which you in the Congress have wrestled with several times in recent years: How to preserve the stock of Federally-assisted housing for low-income tenants when it would be more profitable for the owner to convert the property to higher-cost rental units or condominiums.

In my testimony, I will discuss the issue of tax incentives which of course are under the exclusive jurisdiction of the Committee on Ways and Means. I am pleased that your letter of invitation also requested discussion of the recently enacted housing law. This new legislation, plus some long-standing authorities in existing statute and a proposal for rural housing vouchers in the President's FY 1989 budget, will give you the total picture of the tools we have to work with. I should also point out, however, that the Treasury Department will present the Administration's views on HR 3663.

By way of background, FmHA is the Agriculture Department's credit agency for agriculture and rural development, providing direct or guaranteed loans for farm ownership and production, rural housing, community facilities such as water and waste disposal systems, and business and industry. Our housing programs include loans for ownership of single-family homes, and for rural rental housing.

Our rural rental housing program is carried out under the authority of section 515 of the Housing Act of 1949. Loans are made for 97 percent of the development cost of the project and are amortized over 50 years. Rents are based on operating and maintenance cost and amortized payments. The note rate for 515 loans is currently 9.5 percent. Traditionally, the agency has had two programs that allow us to reduce rents in a manner similar to HUD section 8:

-- The interest credit (IC) program, which reduces the interest rate paid by borrowers to as low as 1 percent so as to reduce rents to 30 percent of tenants' income; this benefit must be passed on to the tenant. This has been the primary method of matching rents with very low and low income tenants intended to benefit from the program.

-- The rental assistance (RA) program, a further subsidy allowing us to reach even lower income tenants who cannot afford to pay the minimum rent made possible with interest credit assistance.

By the end of fiscal year 1987, 14,307 rural rental housing projects accounting for 357,675 individual living units, had been financed under the 515 program. When the program was instituted, there was no restriction on prepayment of these loans. Many of the borrowers were local people and small contractors who got into the program to build units and generate cash flow. In the mid-70s, however, the type of borrower began to change. Syndications of limited partnerships began to get into the program to take advantage of the tax laws. These were primarily in the form of accelerated depreciation. The benefits of these incentives were generally depleted within 7 to 10 years, after which borrowers would find it financially advantageous to sell their projects.

In 1979, it was recognized that in some cases tenants were being displaced from 515 projects in sections of the country where high growth rates were stimulating demand for housing. In response, the Congress amended the law to require that new section 515 borrowers be obligated to maintain the use of the project for low and moderate income tenants for a period of 15 to 20 years, depending on the type of loan. Since this applied only to new loans, borrowers whose loans were made earlier remained free to prepay. As a result, displacements continued to be a problem. Nationwide, approximately half of the projects and almost half the units were financed prior to the requirement and thus are not covered by use restrictions.

Prior to fiscal year 1987, there was strong demand for 515 loans by limited partnerships which then syndicated the projects at a value of approximately 25 percent of the loan amount. Projects did not need to have rental assistance associated with them in order to be attractive to investors, although both interest credit and rental assistance were factors in the location of a project.

The Tax Reform Act of 1986 eliminated accelerated depreciation tax benefits and replaced them with a tax credit.

During most of fiscal year 1987 we saw a dramatic decrease in investor interest in the 515 program; we attributed this decline to the Act. Then something happened and things began to change. We believe that investors found that alternatives to housing investments were not as attractive as they might have appeared. In addition, the Congress shifted $115 million in 515 loan funds to the rental assistance program, which led to creation of 10,000 rental assistance units. The resulting combination appears to have rekindled investor interest and syndication has picked up. However, the benefits are now being marketed in the range of 16-19 percent of the loan amount. The success of the 515 rural rental housing program in providing housing for very low and low income tenants appears to be dependent on investors' obtaining the 4 percent tax credit and being able to assure a high percentage of very low income tenants. Rental assistance enables very low income individuals to afford rental housing in sufficient numbers for owners to qualify for the tax benefits.

One clear indication: Prior to the Congress' action in shifting funds from loans to rental assistance in fiscal year 1987, we projected that we would use less than 50 percent of the loan funds. After the shift, we had a dramatic increase in demand resulting in the use of all funds. For fiscal year 1988, the Congress also transferred loan funds to rental assistance, and we predict that all Section 515 loan funds will be used.

These changes, however, did not directly address the prepayment/preservation issue, which has been addressed in a different manner to some extent since the 1979 restrictions were enacted. In October of 1986, the Congress placed a moratorium on prepayments to provide time for a solution to be found. This moratorium has been continued repeatedly, with only short lapses, up to now. Meanwhile, FmHA has eased the problem administratively within the constraints in existing law.

On February 5, 1988, the President signed into law new housing legislation which contained language affecting prepayment. The provision imposes prepayment limitations on loans made prior to December 21, 1979. FmHA expects to have implementing regulations in effect in April. Under the new law, if a borrower who is not subject to restrictive-use limitations expresses the wish to prepay, FmHA will take the following steps:

--Determine whether the housing is needed for the low income market in the area in which it is located.

-- If the property is needed, accept prepayment only if the borrower agrees to maintain the housing for the low income market for the remainder of a 15 or 20-year period based on the date of the loan.

--Provide incentives to borrowers unwilling to make the commitment which I just mentioned. In exchange for the incentives, the borrower must agree to maintain the housing for low income rental purposes for an additional 20 years. Such incentives include:

* Interest subsidy, if none is currently available to the project.

* Additional rental assistance for the project.

* An increase in the allowable return on investment from the current 8 percent to 10 percent.

* A loan for equity of up to 90 percent of the value of the project. The borrower, or anyone who purchased the project from the borrower, would have unrestricted use of this equity loan which would be made under the same subsidized conditions as the other section 515 loans. This is most important. Other than tax incentives, we see this as the only incentive which will do the job of inducing borrowers to maintain the housing for low income people.

If the borrower refused to accept the incentives, he or she would be required to offer to sell the project to an existing non-profit borrower or public agency at a fair market value. FmHA would authorize a transfer of the existing loan and loan the full amount of the equity plus the costs to the non-profit purchaser to accomplish the sale. The non-profit corporation would have to agree to maintain the housing in the program for its remaining useful life. If no such offer were forthcoming, or if the necessary funds were not appropriated, we would have to accept the prepayment. Displacement problems for tenants would occur although they have been reduced somewhat by regulations promulgated by FmHA in 1987 which provide that:

* Tenants must now receive a minimum of 6-months notice, rather than the previously mandated 30-days notice, prior to the displacement.

* Displaced tenants now receive priority for units in FmHA projects nationwide rather than locally and receive this priority for a longer time period.

* Displaced tenants receiving rental assistance can have it transferred to any other FmHA project to which they move.

These options in the new housing act were explicitly made subject to appropriations, and no funds have yet been appropriated.

In addition, I should note that of the 21,100 units assisted by the rural housing voucher program proposed in the President's FY '89 Budget, 1,200 would be earmarked for families displaced by prepayments in Section 515 projects. This is the number we estimate may be affected by prepayments in FY '89.

With that, Mr. Chairman, I conclude my prepared testimony and will be pleased to receive your questions. Thank you.

Chairman **Rangel**. Thank you, Mr. Clark. Mr. MacRae, in looking over the tax credit, do you believe that this is good housing policy, that it could be part of a good HUD policy, to incorporate it into whatever you have over in your shop?

Mr. **MacRae**. I think the tax credit complements very well our housing policy. The tax credit is focused in terms of eligibility: households have to be less than either 50 percent of area median income, or 60 percent of area median income; our housing policy with respect to vouchers and certificates say they have to be less than 50 percent of area median income. The tax credit has a rent cap on it. Rent will not be paid higher than 30 percent of qualifying income. It corresponds to the basic mechanism of affordability by which our section 8 certificate payments are calculated and our voucher payments are calculated.

Chairman **Rangel**. So you don't see this as in conflict with your voucher program but really as a complement.

Mr. **MacRae**. Absolutely, they definitely complement one another.

Chairman **Rangel**. And I gather that HUD is willing to work with Treasury to think of additional—I don't want to use the word "subsidies"—but incentives to make certain that the credits can work?

Mr. **MacRae**. Well, indeed, we have always worked together. We worked together in the development of the credit with members of your committee and, of course, the Senate Finance Committee. At this point we feel that all that is needed are the particular technical corrections and changes with respect to the omnibus bill. The story is yet to be told regarding the longer term success or ultimate problems that may result with the tax credit. At this point we would not propose any other changes than the ones I have described.

Chairman **Rangel**. But you mention in your testimony that the credit may not work in areas that have very high construction costs, and I come from one of those areas. Is HUD prepared to make housing suggestions as to how it can work, or do you have to get an okay from—well, is HUD prepared to make any suggestions as to when you find extremely high construction costs, what do you do?

Mr. **MacRae**. What we do, of course, is we look at the total supply of housing, not just necessarily the supply that would be coming forth from new construction. And we have to look at the particular market case. As a nation as a whole we do not have a problem of housing availability. Right now we have average vacancy rates on the order of about 7½ percent, and vacancy rates at the rent level of about 9 percent.

Chairman **Rangel**. Mr. MacRae, I know—I've heard the Secretary say about housing for the homeless, that if only they could move to the areas where the housing is located—and I don't have any problem in suggesting to my homeless constituents to move to Wyoming and Utah—if you think it makes sense, I'm not arguing with you.

What I am saying, for those who want to stay in the general area where they were born and raised, and for those who are in there without any housing—and we are trying to build housing there—it doesn't help to tell us where we have housing in some other part of the country. Could you help us to meet those higher construction costs with some suggestions that make sense and complement your restricted resources in terms of housing programs?

Mr. MacRae. Well, we do feel that the primary source of support that is coming forth right now is through our housing voucher program, and that is designed to provide affordable housing for areas, even where there are high construction costs or low median income.

Chairman Rangel. Okay. And, Treasury, you know that a lot of HUD mortgages expire, as you said in your testimony, the 20 years are up, the prepayment clauses obligations are over—do you have any idea how we can keep these houses in moderate income on the market rather than having them converted for market-value rents?

Mr. Steuerle. Mr. Chairman, I don't think that the Tax Code is going to be the major mechanism by which we are going to solve this problem. We have supported a technical correction to the tax credit that would deal with the conversion situation, especially where there was some threat to the Federal housing funds through HUD, Farmers Home Administration, or FHA. One point I'd also like to make in this example, though, is that when we are spending, say, a thousand dollars of subsidy for housing, we want to make clear that we are getting the most bang per buck. It's not always clear that preventing a conversion is necessarily the most efficient way of spending this money. For instance, if it would only cost $1,000 to prevent a conversion, it's not clear we would want to provide a tax credit of $10,000 to prevent that conversion, the extra $9,000 would then be lost to targeted housing assistance we may have elsewhere.

So, yes, we are going to work to try to allow conversion situations to be eligible for the credit. However, again, that does not mean that we think that all conversion situations should receive the credit and deter other uses of the credit for more worthwhile projects.

Chairman Rangel. Do you find that same relationship with the mortgage interest deduction for taxpayers, that that is putting more housing on line as a result of it? I mean, do you support the mortgage interest deduction?

Mr. Steuerle. Yes, we support the mortgage interest deduction, that's correct.

Chairman Rangel. And are the losses there substantial? I mean, do you really think you are getting your bang for the buck, as you said, with that category of taxpayers?

Mr. Steuerle. Well, there are several problems in this area. One is that the real tax benefit for home ownership is due to equity ownership of the home. The benefit is not necessarily due to the interest deduction. The person who takes the interest deduction has a corresponding lender who is getting an interest receipt; that does not necessarily lose revenues to the Treasury. What loses revenues is the fact that the housing itself provides an imputed rental value, in economic terms. Generally, in the Tax Code, we do not try to tax imputed rent. The more one would go after limiting interest deductions, including those of low-income individuals, the more one would provide a tax break for people who owned their houses outright but not for those who had to borrow to buy houses. And we would not favor that type of discrimination.

Chairman RANGEL. Are you working with HUD in trying to see how we can come up with a combined program that would take their limited resources with whatever tax incentives we can to make certain this program works?

Mr. STEUERLE. Yes, we are, Mr. Chairman. Again, as we say, we want to examine this credit very closely to see whether this type of supply subsidy can work as a complement to existing programs. We do have some concerns about the efficiency of this particular type of supply subsidy. For instance, we worry about the fact that this type of subsidy is restricted as to the housing individuals can use. The credit doesn't give individuals the ability to more freely decide what housing they need. For instance, if they would like to have housing closer to their job or housing closer to a family that might be providing childcare assistance—may not be feasible if only certain housing receives a subsidy. That's the reason we tend to favor the housing voucher approach that HUD supports. We think the housing voucher gives more freedom to individuals to choose more efficient housing.

So we are trying to see how this credit can complement the housing voucher program.

Chairman RANGEL. We've had a tremendous delay in getting this program started. A lot had to do with the States and some had to do with Treasury getting the regulations, but do you believe the fact that we only have 2 years remaining on the program might restrict the number of developers that would be interested in it? In other words, do you think it might make more sense to extend the program so that we can get an accurate assessment as to whether or not it is working?

Mr. STEUERLE. Mr. Rangel, I really don't think that's the principal problem in terms of getting the program started. I think the principal problems are those you identified. It's a new program and in many cases it must involve a totally different class of investors than we had for former tax breaks. There are a lot of individuals involved—syndicators, developers, housing officials. That, by the way, is one of the costs of using this type of mechanism: we are losing some of those funds that could go to individuals, by having so many people having to be involved and plan this. Nonetheless, in the initial stages of any new program, we end up having these types of delays.

As far as housing that would be eligible for the credit, we expect that it would be eligible for the full 10 years of the credit, even though the question of whether new housing would be eligible in 1991 or beyond is still open to question. So we don't think that question—whether we have a credit for 1991 for housing developed after 1991—is really a major impediment.

But the other issues that you raised, indeed, are problems that we are trying to resolve. We are trying to get out the regulations to make it easier for people to use the credit so we can test to see whether the program is working.

Chairman RANGEL. None of you believe that there is anything that we would have to do in this session of Congress to make certain that the laws would apply after the end of the year, or for a new administration—we are pretty secure in the law; I mean, we don't need to do any additional?

Mr. STEUERLE. Well, we do support a number of technical corrections, Mr. Chairman.

Chairman RANGEL. I know.

Mr. STEUERLE. In fact, I think you made a very imaginative suggestion in your remarks, for instance, as to changing in a revenue-neutral fashion the time period in which one is able to claim eligibility for the credit, that is, allowing some carry-forward to future years. We believe changes like that could enhance the administrability of the credit.

Chairman RANGEL. Well, we hope that the three of you would be available to work with teams to see how we can make certain that existing law really works, notwithstanding whether we like it or not—it is the law of the land, and it is really the only thing that we have going for us for low- and moderate-income housing. And I would appreciate whatever cooperation you can give.

Mr. Duncan?

Mr. DUNCAN. Thank you, Mr. Chairman. I have no particular question other than to thank the panel—I think it's one of the better panels that we've had. And I think the subject is one of the most important ones that we have. And I also compliment you, Mr. Chairman. I don't know of anyone that's taken more interest in seeing that people are in decent, livable housing than you have in this entire Congress, and I hope that we can do something as soon as possible. I know that we have some constraints on revenues, or whether or not we open the Tax Code further. But I know the tax incentives have been helpful, from my vantage point. And the reason I dropped in—I'm an ex officio Member of this committee, but I'm always pleased to be here with you, Mr. Chairman.

Thank you.

Chairman RANGEL. Mr. Duncan, you have really been a great supporter and provided the leadership to make certain that this never even appears to be a partisan issue, and we couldn't even have reached the limited successes we had if it wasn't for you—and I want to thank you publicly.

Mr. Stark?

Mr. STARK. I apologize, Mr. Chairman, for being late. But I am curious—I noticed in Mr. Clark's testimony you have suggestions for solving the problem of what happens when a mortgage expires, or there is prepayment, to make sure we don't diminish the stock of housing units available. That's kind of a hidden cost, I think. I noticed that after units that have come to the end of their 20-year string in my district, suddenly we are back here asking for vouchers, which is a cost we didn't anticipate when we analyzed what we were going to do 20 years ago. And I am concerned about what will happen prospectively on any new fix, to put it in. And I am just wondering—I believe, Mr. Steuerle, in other areas, such as tax incentives for conservation and scenic and historic things, we put an easement that runs in perpetuity on property as a requirement for the tax incentive, is that not correct?

Mr. STEUERLE. That is correct.

Mr. STARK. Or for credit for historic rehab, you have to put an easement on a piece of property that you will leave the facade, or whatever it is that's historic, in place in perpetuity, isn't that correct?

Mr. STEUERLE. That's correct. Part of that is for administrative purposes.

Mr. STARK. Why, then, wouldn't it be a good idea—and I would ask each member of the panel—just for us to do that: say, all right, we'll extend the credit, or whatever incentive is necessary, but then let's ask for a perpetual easement, that this property be dedicated to low-income housing. There could be escape valves—HUD is asking for some now under the present program. And the property could, if the owners didn't want to keep, be sold to a State housing agency or a nonprofit group at the end of the time—but you put in an easement. And wouldn't that solve the problem, Mr. Clark, that you are trying to get at in your testimony?

Mr. CLARK. I'm sitting here thinking as an investor. I think I would find that rather discouraging. I'm not sure I'd want to get into a program with that perpetual cloud hanging over you.

Mr. STARK. Wouldn't that be entirely dependent on your return, on your investment return?

Mr. CLARK. Yes, but I'm not sure that would be incentive enough for me to do that.

Mr. STARK. Well, when you make an investment, you think of a rate of return, don't you? An internal rate of return or a current cash flow. And you have an objective in mind, 10, 12, 30 percent. Do you really care?

You know, if you invest in oil, that's going to disappear some time. You really look at either your cash flow or—all I'm suggesting is you take that into account on any investment you make.

So if the incentives are there, are high enough, as an investor, unless you get very emotional about handing down a piece of land for 18 generations like a grant from the crown, but other than that, I suspect that most sophisticated investors learn not to fall in love with any particular investment.

I suggest that maybe this takes a lot of this discussion off the table. We do it in other areas. A lot of farmers swap farms, but they'll put a conservation easement on and give it to Ducks Unlimited, for example, and they still farm grain, and it doesn't affect the value of the farms.

And I just wonder, what do you think, Mr. MacRae, how would this fit in with your program?

Mr. MACRAE. I think there's certainly the point that what an investor really does look at is the return. And the vast majority of any return comes well before perpetuity. And I guess I don't dare quote John Maynard Keynes, "in the long run we're all dead".

But the real question is whether there would be a matching of benefits over the life of that project to match the restraint.

A concern is that if you give all the benefits up front, or over a period of time, and then there are no future benefits, the natural inclination of the investor is not to maintain his property.

And even though it may still be available for low income use, it may not be the suitable, available type of housing that we would want.

What we have proposed in terms of extending the waiver benefit to deal with prepayments is to allow this credit, which is a finite term with benefits spread over 10 years and which has a finite requirement that the housing be maintained for low-income families over 15 years, to be used for prepayments.

And let me say that we're very concerned, and we think we can deal with the problem, of having a wasteful level of benefits.

In our own minds, we divide prepayments into three classes: Those that are going to prepay no matter what. They're in a situation where the market rate situation means that the tax credit will not induce them not to prepay.

Those that will not prepay because the market rate situation is not such that it would be attractive to prepay. For both of those two classes, you don't want to use the credit. It's either not good enough, or you're not going to spend the resources wisely.

The proper level of using the credit for a waiver would be those that but for the credit would prepay. So we think that the way it should be implemented were——

Mr. STARK. How about prospectively, though, to prevent this problem from coming up 20 years from now and saddling our heirs with the problem of the one we're facing now? Why don't we just crank it into existing law?

The example you cite of someone who has got 5 years to go, and you say they may not maintain it. I doubt whether, if they know they're going to put a parking lot where this low income housing is, whether they're going to be any more constrained to maintain the housing in the last 5 years of its existence if it's under an easement that requires it to stay as housing, or whether they're going to tear it down.

I think that if there aren't reasons enough for the landlord to maintain the property, and they know that there is a cutoff point somewhere down the line, that that decision cuts both ways.

But that decision, as you say, we do it. There are all kinds of easements on properties. It isn't as if it's a scarlet letter stamped on the property's deed forever.

But I am suggesting that it puts the responsibility on somebody to come back to you at HUD, or to the local housing authority, or the Farmer's Home Authority, and say, we can prove to you we don't need this property any more for low-income housing.

We put the restrictions in, but as long as they've got to take the initiative and come back to you and take that housing stock out of the market.

And I like having the first serve, that's all. And I think if we're going to give the credit, let's lock in that provision up front.

We may have to raise the credit enough to get Mr. Clark to invest to make it an attractive investment form. But I'm saying, that sure solves the problem that somebody created 20 years ago, and we're here debating it today.

If they'd done this 20 years ago, our problem would be solved today. And I hope you'll consider that.

Because I think, carefully drafted, it wouldn't prevent the program from working, and might be a good protection for the future.

Mr. Steuerle?

Mr. STEUERLE. Mr. Stark, if I might suggest, if you want to keep this housing and low-income housing longer, it seems to me that in fact what you want to do is make the rate of payment more proportional to the benefits that are being given to low-income individuals.

In some sense that's what a housing voucher program does, although a housing voucher also gives you a little more flexibility, because it also says that if this housing, for instance, becomes very valuable, if the land under it is very valuable, that maybe we don't want to spend that amount of money maintaining what is now high value property, but switch over to low value property.

Mr. STARK. No problem. But then somebody has to come back and prove it to Mr. MacRae. And they have to show, and Mr. MacRae has to really be sure that he's going to get housing units that go to low income to replace the ones that are being taken out of the market.

And all I'm saying is, you put the burden of proof on the landowner. And in the absence of showing where that, satisfying whoever is responsible, that the low income housing is going to be produced, you just have an easier enforcement job. And that's all I'm suggesting.

I happen to think that something like the 235 program was super. I liked that even better than the vouchers. But that seems to have disappeared somewhere down the line.

I'd like you gentlemen to think on that awhile, and see whether it really wouldn't be a lot simpler than all the restrictions Mr. Clark has suggested and what Treasury has suggested, and just say, look, raise the incentive high enough.

But you go into the program, and you consider it there permanently. You have to prove that it's in the public interest to remove the easement. It might be a lot simpler 20 years from now.

Mr. MACRAE. We will of course be delighted to consider that. And I know my colleague Tom Demery shares all of our concerns on prepayment.

I would only say, the credit itself potentially right now is very attractive, save but for the passive loss limitations, which tend to limit its use except for corporations and individuals who qualify for it.

So there's always a dilemma when you start to crank up that credit more and more to try and deal with what is really a long term problem.

I share your concern, but we must look at the tradeoffs.

Mr. STARK. Well, we can always trade a little. There's always room for negotiation, Mr. MacRae.

Thank you very much. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Coyne?

Mr. COYNE. No questions, Mr. Chairman.

Chairman RANGEL. To follow through on what Mr. Stark was saying, I recognize that the three of you—and especially HUD and Treasury—are restricted by the existing policies of the administration.

But it could be helpful, assuming that your tenure expires at the end of the year, if you could give us your professional ideas without being encumbered by Democratic, Republican, liberal or conservative views, as to what could provide the maximum amount of shelter for lower income people, and then maybe next year we'll be in a better position to wrestle with the political problem.

So I do hope that you would feel free professionally to do that without doing violence to your loyalty to, in your case, Mr. MacRae, whomever and whatever.

But I thank you for your input as to existing law, and look forward to your support in trying to make this existing law as successful as possible in getting the maximum benefits from it.

And I thank you, Mr. Clark, for your input.

Mr. MACRAE. Thank you, Mr. Chairman.

Chairman RANGEL. Look forward to working with you.

Mr. MACRAE. May I say, personally, we've had an excellent opportunity to work with you and with your staff. And we look very much forward to continuing that interaction that we've had in the past.

Chairman RANGEL. The staff is so advised. And I really appreciate their support, even though you opposed the concept. You still worked with us. And I hope to be working with you this year as well as next year.

Mr. MACRAE. Thank you.

Chairman RANGEL. The next panel is the Association of Local Housing Finance Agencies, Kenneth Johnson, director, of the city of St. Paul, Department of Planning and Economic Development; the National Council of State Housing Agencies, Executive Director Terrence Duvernay, Michigan State Housing; and of course, from the city of New York, our new commissioner, Abraham Biderman, who is the commissioner of housing, preservation and development, and he'll be with James Yasser, who is the president of the New York Housing Development Corp.

Now, most of you know that if there is no objection from the committee, your entire prepared statements will be entered into the record, and you should feel free to just highlight it so we could reserve most of the time for the questions from you.

And the Chair hearing no objections, so ordered. And we will start with Mr. Johnson.

STATEMENT OF KENNETH R. JOHNSON, IMMEDIATE PAST PRESIDENT, ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES, AND DIRECTOR, DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT, CITY OF ST. PAUL, MINN.

Mr. KENNETH JOHNSON. Mr. Chairman, and members, on behalf of the Association of Local Housing Finance Agencies, known as ALHFA, I appreciate the opportunity to appear before you today, and to discuss the low income housing tax credit as an instrument of Federal housing policy.

As the Chair indicated, my name is Ken Johnson. I am the director of the department of planning and economic development for the city of St. Paul, Minn., and I am here today as immediate past president of our Association of Local Housing Finance Agencies.

By way of background, Mr. Chairman, ALHFA is a nonprofit national association of professionals in the field of affordable housing finance. Our 133 member agencies are city and county government agencies, mainly in urban areas, which finance home ownership and rental housing opportunities for low and moderate income persons.

At the outset, Mr. Chairman, I want to commend you for holding these hearings focusing on policy issues and constraints with respect to the low-income housing tax credit. As you no doubt learned, despite your best efforts to insure that adequate tax incentives to stimulate meaningful production of new rental housing for low- and moderate-income persons remained after Congress passed the 1986 tax act.

In our judgment that has not been, nor is it now the case. The reasons why, and what can be done, are points I want to develop in my testimony.

Before doing so, however, there is a separate but related issue before the Congress on which I want to comment today, which involves a tool used by local and State housing finance agencies to meet affordable housing needs, and that tool is the mortgage revenue bond program.

Current authority to issue tax exempt mortgage revenue bonds, the proceeds of which are used to make mortgages to first time homebuyers, expires December 31, 1988.

H.R. 2640, introduced by Representative Donnelly and cosponsored by you, Mr. Chairman, and 205 of your House colleagues, is now pending before the Ways and Means Committee.

I want to use this opportunity to strongly encourage its prompt consideration and approval by the committee, and by the full Congress, during this session.

Owning one's own home has long been characterized as the American dream, but that dream, however, has become more elusive for many potential homebuyers today, first time homebuyers, unable to qualify for conventional mortgage assistance.

A sharply targeted program like the mortgage revenue bond program, to those below a certain income limit, and for homes up to a maximum purchase price limit, can make a difference in housing affordability for those first time homebuyers throughout the Nation, Mr. Chairman.

Issuance of MRBs is a legitimate public purpose, and a policy tool of the Congress. And we urge its continuance and enactment or continuance.

I would like to shift my attention now to the low-income housing tax credit. Conceptually, we agree with the previous speakers representing the Federal agencies that the credit represents a legitimate use of the Federal Tax Code to stimulate investment in an activity which otherwise would attract little if any interest from investors.

The reason for this is that targeted rental housing projects are not an economic investment, and must rely on other factors, such as tax benefits.

In addition, the type of project to be assisted, one which contains a certain percentage of units set aside for low income persons—as the chairman knows, 20 percent at 50 percent of median, or 40 percent at 60 percent of median income—is also conceptually proper Federal housing policy.

This is so because it targets assistance to low income persons, and it also allows us to reflect on the lessons we learned from previous Federal housing programs, one of which is that mixed income projects promoted a positive housing environment, and a housing attitude.

But while the low income housing tax credit program is fine in concept, we differ from the previous speakers representing the Federal agencies, from our experience in the field, in that the credit suffers from serious shortcomings which impair its full utilization as the Congress we believe intended.

The credit, even with tax exempt bond financing, Mr. Chairman, is of insufficient value to the private sector to stimulate new rental housing production in the absence of additional subsidy.

That is, it is generally not possible to do the targeting required, targeting which ALHFA supports, using only the tax credit and tax exempt financing. Projects simply don't pencil out, and the rate of return to the investors isn't there.

To digress for a moment, Mr. Chairman, if 7 or 8 percent rate of return for investors is the kind of rate of return that is produced by this credit, which is the case for most projects today as the credit currently stands, an investor is far better off taking no real estate risk and investing in a certificate of deposit in the federally insured institutions as provided by this Congress.

This experience with credit is in sharp contrast to the success of local housing finance agencies previously in stimulating production of new and moderate income rental housing, prior to the 1986 tax act, using tax exempt bonds, and the associated real estate incentives, such as passive losses.

Evidence of the dramatic adverse impact which the 1986 act's provisions had is reflected in the decline of tax exempt financing, which was $5 billion in 1984 for rental housing for low and moderate income persons; $20 billion in 1985; and then falling as a result of the act to a little over $3 billion in 1986, and under $3 billion in 1987.

Those projects which have used the tax credit have often involved the acquisition and rehabilitation of existing projects, where 100 percent of the units are and remain low income.

In such projects the credit is maximized by its application to all of the units. While we have no objection to this, it does not add to the stock of new, low and moderate income housing which this Nation so desperately needs.

Furthermore, it ignores the positive lessons we've learned from mixed use projects through the years of administering Federal housing programs.

I would like to take a moment to relate our experience in St. Paul with the tax credit. As you know the 1986 act provides for an allocation of tax credit authority among the States based on $1.25 per capita, for reallocation within the State by its housing credit agency.

To our knowledge, Minnesota is the only State which has enacted legislation providing for an allocation of a portion of its credit authority ceiling to certain cities and counties within the State of Minnesota.

In 1987 within the State of Minnesota, there are seven cities and two counties receiving about $2.5 million worth of credit authority, which is roughly half of the State ceiling of $5.25 million.

St. Paul's 1987 entitlement was $541,452. Of that amount of authority allocated by the State law to the city of St. Paul, the city of St. Paul has been able to use 63 percent of that authority, or about $341,000, which was committed by the October 1987, deadline imposed by the State statute for eligible projects placed in service prior to the end of the calendar year.

St. Paul's success, however, in committing 63 percent of its credit authority is in marked contrast to the experience among other housing credit agencies. A study conducted last October for the National Council of State Housing Agencies, from which you will hear shortly, projected that only 16 percent of the tax credit authority available nationally would be allocated in 1987.

I believe that figure today has increased to around 21 or 22 percent by the end of the year, according to the National Council of State Housing Agencies.

Why we in St. Paul were able to make the credit work for these projects is of interest. The answer to that, in a word, is subsidy. Substantial local fund subsidy, provided either by the Minneapolis-St. Paul family housing fund, which is a nonprofit lender created through the years to channel local contributed and other philanthropic money to low income housing, or by local subsidy dollars, non-Federal dollars, contributed by the city of St. Paul.

Those two major subsidy sources are the reason, and the only reason, that we in St. Paul have been able to make this program work at all.

The low amount of the first mortgage loans represented by the kinds of projects we have financed, which is contained within my written testimony, is indicative. We have found that we've been able to finance, through a first mortgage loan, conventional loan, with lenders, only 18 percent of the total development cost of a project.

This is in market contrast to the experience that we normally have found prior. And in that, the private market finds were 80 to 90 percent of a project cost can be financed with first mortgage proceeds from conventional lending sources.

And the reason for this, of course, is that the rents simply do not carry any debt service on these projects. And so the credit is not sufficient without additional local subsidy to make the project pencil out.

The subsidy amount is higher than we had expected, when we originally analyzed prototypical rental projects, both in St. Paul, and within the Association of Local Housing Finance Agencies.

In addition to the significant dollar amount of the subsidy, the structure of the financing is such that no repayment is made until the end of the 20-year term. So while we in St. Paul, when we make these subsidy contributions, call them a loan, they are actually a grant, because they do not amortize again, because the project cannot carry any debt service.

So the subsidy funds we will not see back, and cannot roll over into other low income housing uses for 20 years.

The private equity dollars which we have been able to attract into these projects have been attracted largely because of the tax credit. As noted above, rental housing projects are not expected to generate much tax flow.

Tax reform has also eliminated most passive loss tax benefits. And appreciation of property value is not expected to be significant.

Therefore, an investor's assessment of the three primary components of return on equity—cash flow, tax benefits and property appreciation—will focus primarily, if not solely, on benefits related to the low income housing tax credit.

Again, while St. Paul's experience has been positive, I have to point out again that the projects we've done have been small. We've done only about 48 new construction units, and 8 substantial rehab units. And we've relied on that substantial infusion of additional local subsidy.

We've been fortunate to have that subsidy in contrast to most other cities and counties, which do not have those subsidy funds available. But even for us in St. Paul, our ability to continue a subsidy level of around $35,000 a unit, in local subsidy funds, in addition to the credit, is certainly not unlimited.

And we'll be doing our last deal very soon unless the credit is made more workable.

From a national perspective, Mr. Chairman, we in ALHFA do not believe the tax credit is working the way Congress intended. Other than the three new construction projects which St. Paul has undertaken, the only other new construction project undertaken by local housing finance agencies of which we are aware are, first, an $8.2 million 132-unit project undertaken in December in Freemont, Calif.; and 32 townhomes totally about $2.5 million here in suburban Washington and Montgomery County, Md.

There may be others, but these are the only ones with which we are familiar.

In an effort to identify what modifications to the tax credit are necessary to improve its utility as a stimulus to significant new housing production in the absence of additional subsidy beyond tax exempt bonds, we analyzed prototypical rental housing projects in six jurisdictions around the country—Atlanta; El Paso County, Colorado, which is Colorado Springs area; Fairfax County, Va., here in the Washington area; Los Angeles; Minneapolis-St. Paul; and Montgomery County, Md.

The analysis included a number of underwriting assumptions which are detailed in my written testimony.

We found that in addition to tax exempt financing, the level of construction costs had a direct bearing on project feasibility. And that is, where construction costs exceeded the national average, projects were either less feasible or not feasible at all.

This finding led to application of a high cost adjustment which HUD utilizes in 77 high cost cities around the country for such programs as the HDAG, housing development action grant program, for example.

A high construction cost adjustment, applied to a project's eligible basis, improved feasibility, but still fell short in high cost areas.

In our analysis, we next considered various credit alternatives, and found that project feasibility was improved through application of a general credit on all of the units within a project, plus an additional credit on the targeted units.

We also found that the larger the project, in terms of number of units, the greater its feasibility.

Our analysis concluded that the tax credit's value must be substantially increased, Mr. Chairman, in order to make new construction projects financially feasible to the private sector in the absence of additional large amounts of subsidy of the type I've detailed to you from our St. Paul experience.

The following we recommend. First, permit an adjustment to eligible basis of projects, for projects located in FHA high housing cost areas. This is consistent with other Federal housing programs, and the history of Federal housing policy, and it's necessary to help equalize construction costs in these areas, compared to construction costs around the Nation as a whole, taken as an average.

Second, provide a general credit for all the units in a project, together with an additional credit for the set-aside units.

A credit on the set-aside units alone, even with tax exempt financing, Mr. Chairman, is insufficient to make up for the lost rental income which the targeting demands.

Extending the credit to all of the units has precedent in the special credit allocation provided to the city of Chicago and the city of New York in the 1986 Tax Act.

We believe that these changes could be made while keeping the program within the overall cost permitted by the Congress if all of that which were authorized were utilized.

Today, Mr. Chairman, the insufficient incentive to the private sector of the credit as it stands prohibits the full utilization of the credit at anywhere near the levels that Congress intended when they allocated the credit for the production of lower income housing.

As a related matter, Mr. Chairman, we urge the Congress approve the pending technical corrections act. However, with all due respect to the previous speakers representing the Federal agencies, passage of the technical corrections act will not, in our judgment, result in the credit becoming a significant national production program for new units of low and moderate income. That simply alone will not do the trick.

Mr. Chairman, the tax credit has the potential for being a valuable incentive to stimulate investment in low income housing. However, it needs improvement along the lines we've suggested.

And we stand ready, and we look forward to an opportunity to work with the subcommittee and its staff in fashioning those changes to achieve the result we believe the Congress intended.

Thank you very much for your indulgence.

[The statement of Kenneth Johnson follows:]

STATEMENT OF KENNETH R. JOHNSON, DIRECTOR, DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT, CITY OF ST. PAUL, MINN.

Mr. Chairman and Members of the Subcommittee:

On behalf of the Association of Local Housing Finance Agencies (ALHFA), I appreciate the opportunity to appear before you today to discuss the low-income housing tax credit as an instrument of federal housing policy; our experience in attempting to use the credit; and suggested modifications to improve the credit's effectiveness. I'm Ken Johnson, Director of the Department of Planning and Economic Development for the City of St. Paul, and I'm here today as Immediate Past President of ALHFA.

By way of background, Mr. Chairman, ALHFA is a nonprofit, national association of professionals in the field of affordable housing finance. Our 133 members are city and county government agencies which finance homeownership and rental housing opportunities for low- and moderate-income persons. ALHFA's purpose is to serve its members as an advocate before Congress and the Executive Branch on affordable housing issues, and, through educational activities, to enhance the ability of local housing finance agencies to implement responsible and professionally-administered affordable housing programs for low- and moderate-income persons.

At the outset Mr. Chairman, I want to commend you for holding these hearings focusing on policy issues and constraints with respect to the low-income housing tax credit. As you have no doubt learned, despite your best efforts to ensure that adequate tax incentives to stimulate meaningful production of new rental housing for low- and moderate-income persons remained after Congress passed the 1986 Tax Reform Act, that has not been, nor is it now, the case. The reasons why, and what can be done, are points I want to develop in my testimony. Before doing so however, there is a separate but related issue before Congress upon which I wish to comment. It involves a tool used by local and state housing finance agencies to meet affordable housing needs -- the Mortgage Revenue Bond (MRB) Program.

Mortgage Revenue Bonds

Current authority to issue tax-exempt Mortgage Revenue Bonds, the proceeds of which are used to make mortgages to first-time homebuyers, expires December 31, 1988. H.R. 2640, introduced by Rep. Donnelly and cosponsored by you Mr. Chairman and 218 of your House colleagues, is now pending before the Ways and Means Committee. I want to use this opportunity to strongly encourage its prompt consideration and approval by the Committee and by the full Congress during this session.

Owning one's home has long been characterized as "the American Dream." That dream, however, has become more elusive for many potential first-time homebuyers unable to qualify for conventional mortgage assistance as evidenced by the following:

o Between 1986 and 1986 home prices rose nationally by 108 percent while median family income rose 97 percent;

o Rents today are rising faster than inflation, siphoning off income which could otherwise be available for a downpayment; and

o Between 1980 and 1986 the percentage of Americans owning their own home fell from 65 percent to 63.8 percent.

In short, what we see is an affordability problem -- a problem addressed at least in part when local and state housing finance agencies makes available below market mortgages [or tax credits through the companion Mortgage Credit Certificate (MCC) program in a sharply targeted fashion to those below a certain income limit and for homes up to a maximum purchase price ceiling. Issuance of MRBs and MCCs is a legitimate public purpose and is a proper use of the Tax Code. Congress should ensure its continuance.

I would now like to shift my attention to the low-income housing tax credit.

The Credit as an Instrument of Federal Policy

The low-income housing tax credit was enacted by Congress to stimulate private investment in the acquisition, rehabilitation, or construction of rental housing for low-income persons. Under the program, a credit of 9 percent for conventionally-financed projects, or 4 percent if tax-exempt bonds or federal assistance is utilized, is available for units set aside for households whose incomes do not exceed either 50 percent or 60 percent of the median income, and who pay no more than 30 percent of their income for rent.

Conceptually, the credit represents a legitimate use of the federal tax code to stimulate investment in an activity which otherwise would attract little, if any, interest from investors. The reason for this is that targeted rental housing projects are not an economic investment and must rely on other factors, such as tax benefits.

In addition, the type of project to be assisted -- one which contains a certain percentage of units set aside for low-income persons (20 percent at 50 percent of median or 40 percent at 60 percent of median) -- is also, conceptually, proper federal housing policy. It targets assistance to low-income persons and it reflects lessons learned from previous federal housing programs -- that mixed-income projects promote a positive housing attitude and environment.

But while the low-income housing tax credit program is fine in concept, it suffers from serious shortcomings which impair its full utilization as Congress, we believe, intended:

1. The credit, even with tax-exempt bond financing, is of insufficient value to stimulate new rental housing production in the absence of additional subsidy. That is, generally it is not possible to do the targeting required -- targeting which ALHFA supports -- using only the tax credit and tax-exempt financing. Projects simply don't pencil out.

   This is in sharp contrast to the success of local housing finance agencies in stimulating production of new low- and moderate-income rental housing prior to the 1986 Tax Act using tax-exempt bonds and the associated real estate incentives such as passive losses. Evidence of the dramatic adverse impact which the 1986 Act's provisions have had is reflected in the decline of tax-exempt multifamily bond volume which was $5 billion in 1984, rising to $20.16 billion in 1985, and falling to $3.16 billion in 1986, and $2.77 billion in 1987.

2. Those projects which have used the tax credit involved, for the most part, the acquisition and rehabilitation of existing projects where 100 percent of the units are and remain low income. In such projects, the credit is maximized by its application to all of the units.

   While we have no objection to this, it does not add to the stock of new low-income housing. Furthermore, it ignores the positive lessons we have learned from mixed-income projects.

Experience with the Tax Credit

I want to take a moment to relate Saint Paul's experience with the tax credit. As you know, the 1986 Tax Act provides for an allocation of tax credit authority among the states based on $1.25 per capita for reallocation within the state by its housing credit agency. (Tax credit authority used in conjunction with tax-exempt bonds does not require an allocation.) To our knowledge, Minnesota is the only state which has enacted legislation providing for an entitlement of a portion of its credit authority ceiling to certain cities and counties.

Under the Minnesota law, eligible cities and counties are (1) cities with a housing and redevelopment authority (HRA) and a population of at least 50,000; (2) cities located in three or more counties which have an HRA; and (3) counties with an HRA and a population of at least 100,000.

Each entitlement community receives an amount equal to the greater of (1) $1.6875 multiplied by the city or county population; or (2) 90 percent of the total state ceiling multiplied by a fraction representing the community's share of rental housing relative to the state. In 1987, there were 7 cities and 2 counties receiving $2.54 million in credit authority, or 48.4 percent of the state's ceiling of $5.24 million. Saint Paul's 1987 entitlement was $541,452.

Of the City's $541,452 in authority, 63 percent or $341,756 was committed by the October 1, 1987 deadline imposed by state statute for eligible projects placed in service prior to December 31, 1987. Those projects receiving a commitment were:

1. Sherburne Avenue Apartments (8 units, rehab)	$ 32,402
2. Lincoln Townhomes (18 units, new)	118,172
3. Carroll Avenue Townhomes (11 units, new)	73,697
4. Clinton Avenue Townhomes (18 units, new)	117,485
	$341,756

Saint Paul's success in committing 63 percent of its credit authority is in marked contrast to the experience among other housing credit agencies. A study conducted last October for the National Council of State Housing Agencies (NCSHA) projected that only 16 percent of the tax-credit authority available nationally would be allocated in 1987. I believe that figure increased to 22 percent by year's end according to NCSHA. Page Eight

Why were we able to make the credit work for these projects? In a word -- subsidy, substantial subsidy provided either by the Minneapolis/Saint Paul Family Housing Fund or the Saint Paul HRA.

The financing package for Clinton Avenue Townhomes is a typical example of why the tax credit worked:

	Total Project	Percent Of Total	Amount Per Unit
Total Development Cost	$1,342,470	100%	$74,470.55
First Mortgage Loan	247,000	18%	13,722.22

Subsidy (Family Housing Fund)	644,827	48%	35,823.72
Private Equity	448,643	33%	24,935.61

The low amount of the first mortgage loan (only 18 percent of total costs) is common to rental project financings undertaken after the 1986 Tax Act. With the deep targeting requirements, projects simply do not generate sufficient income to carry much debt. Prior to the Tax Reform Act, the amount of a typical first mortgage loan was 80 percent to 90 percent of total cost.

The subsidy amount is higher than we had expected when we originally analyzed "prototypical" rental projects. In addition to the significant dollar amount of the subsidy, the structure of this Page Nine financing (it is technically a "deferred loan", not a grant) is such that no repayment is made until the end of the 20-year term.

The private equity dollars have been attracted largely because of the tax credit. As noted above, rental housing projects are not expected to generate much cash flow; Tax Reform has also eliminated most passive-loss tax benefits; and appreciation of property value is not expected to be significant. Therefore, an investor's assessment of the three primary components of return on equity -- cash flow, tax benefits, and property appreciation -- will focus primarily, if not solely, on benefits related to the low-income housing tax credit.

While Saint Paul's experience with the tax credit has been positive, I must point out that the projects we've done are small and have relied on a substantial infusion of additional subsidy, subsidy which we in Saint Paul are fortunate to have, in contrast to most cities and counties which do not.

Improvements to Increase the Credit's Effectiveness

From a national perspective Mr. Chairman, we in ALHFA do not believe the tax credit is working the way Congress intended. Other than the three new construction projects which Saint Paul has undertaken, the only other new construction project undertaken by local housing finance agencies about which we are aware are an $8.2-million 132-unit project undertaken in December 1986 in Fremont, California, and 32 townhouses totaling $2.4 million in Montgomery County, Maryland. There may be others, but these are ones with which we're familiar.

In an effort to identify what modifications to the tax credit are necessary to improve its utility as a stimulus to significant new housing production in the absence of additional subsidy beyond tax-exempt bonds, we have analyzed prototypical rental housing projects in six representative jurisdictions: Atlanta, Georgia; El Paso County, Colorado; Fairfax County, Virginia; Los Angeles, California; Minneapolis/Saint Paul, Minnesota; and Montgomery County, Maryland.

The analysis included the following assumptions:

Underwriting

Maximum Amount of Primary Loan	Not to exceed 80% of Total Project Cost based on projected income
Debt Coverage Ratio	1.20
Interest Rate (Conventional)	10.25%

Interest Rate (Tax-exempt)	8.25%
Amortization	30 years
Assumed Rate of Return	12%

Investor Profile

Tax Bracket	28%
Depreciation Method	27.5 years straightline
Year Property Sold	15th year
Sales Assumption	2% appreciation per year

We found, for example, that in addition to tax-exempt financing, the level of construction costs had a direct bearing on project flexibility. In areas where construction costs exceeded the national average, projects were either less feasible or not feasible at all. This finding led to application of a "high-cost adjustment" which HUD utilizes in some 77 high-cost cities for such programs as Housing Development Action Grants. A high construction cost adjustment applied to a project's eligible basis improved feasibility but still fell short in high-cost areas.

We next considered various credit alternatives and found that project feasibility was improved through application of a general credit on all of the units within a project plus an additional credit on the targeted units. We also found that the larger the project, unit-wise, the greater the feasibility.

Our analysis concluded that the tax credit's value must be substantially increased in order to make new construction projects financially feasible in the absence of additional subsidy.

The following improvements in the credit are recommended: First, permit an adjustment to eligible basis for projects located in Federal Housing Administration high housing cost areas. This is consistent with other Federal housing programs, and, it is necessary to help equalize construction costs in these areas compared to the nation as a whole. Second, provide a general credit on all of the units in a project, together with an additional credit for the set-aside units. A credit on the set-aside units alone, even with tax-exempt financing, is insufficient to make up for the lost rental income. Extending the credit to all of the units has precedent in the special credit allocation provided to the City of Chicago and the City of New York in the 1986 Tax Act.

We believe these changes could be made while keeping the program within the total credit amount authorized by Congress.

As a related matter, Mr. Chairman, we urge that Congress approve the pending technical corrections to the tax credit which were passed by the House during the last session, and to extend the December 31, 1989 sunset on tax-credit authority.

Mr. Chairman, the tax credit has the potential for being a valuable incentive to stimulate investment in the production of new low-income housing. However, it needs improvements along the lines suggested herein. We look forward to working with your subcommittee in fashioning changes to achieve this result.

Chairman **Rangel**. Thank you, Mr. Johnson, for your very thoughtful recommendations.

Before I recognize Mr. Levin, tell me, do you know what impact, if any, the 1986 tax reform law had on the revenues available to Minnesota or to the city of St. Paul.

Mr. **Kenneth Johnson**. Revenues available, Mr. Chairman?

Chairman **Rangel**. Well, the tax structure. Was it changed as a result of the 1986 Federal Tax Reform Act?

Mr. **Kenneth Johnson**. We typically, Mr. Chairman, in St. Paul, prior to the Tax Act, were financing housing for low and moderate income persons through our agency to the level of probably 300 or 400 units of rental housing a year.

Chairman **Rangel**. I didn't make my question clear. The 1986 Tax Reform Act reduced the number of deductions that the taxpayer could take.

As a result of this, most cities that had any type of taxes at all, or certainly the states that piggybacked on the Federal tax system, had a broader base in which to develop their tax system.

In a lot of areas, the taxes, they received additional revenue. Other people passed on that tax saving to the taxpayer.

Do you know what happened in Minnesota?

Mr. **Kenneth Johnson**. Sorry, Mr. Chairman, for not understanding your question. Yes, in Minnesota, due to the operation of the legislature and the revision of State taxes, none of that was passed on to the localities in terms of extra available revenue for our use in housing or any other means.

Chairman **Rangel**. Was application made for additional revenues for low income housing by the State legislature?

Mr. **Kenneth Johnson**. I'm sorry, sir?

Chairman **Rangel**. Did the State legislature make any recommendations for some of those tax revenues that were available to be made available for low income housing, do you know? Were there any new initiatives by the cities and States in this area?

Mr. **Kenneth Johnson**. Yes, cities have launched an initiative in the legislature which was not successful last session. We hope maybe this session. It does have some support in the legislature.

However, it's not going to be at a scale that would allow us to continue to produce housing at a level we were experiencing in '85.

Chairman **Rangel**. The Chair now would recognize Mr. Levin, a distinguished member of the full Ways and Means Committee, for the purpose of introducing our next witness.

Mr. **Levin**. Thank you very much, Mr. Chairman. And I appreciate the chance to join you, the distinguished chairman and my good friend, and the other members of this subcommittee; I don't have the privilege of serving on it.

But I thought I would drop by, and I appreciate you letting me do so, for the testimony of Terrence Duvernay, who is the executive director of MSHDA.

As I remember it, Mr. Chairman, the agency, the authority, was created when I was in the legislature. That was a few years ago—the State legislature. And it's had a distinguished history.

It's been the creator of a great deal of housing within the State of Michigan. The State would be much poorer without it. And he's also Secretary of the National Council of State Housing Agencies, so I know that all of you join in anticipation of his testimony.

Chairman RANGEL. Well, the Chair welcomes the contribution the gentleman from Michigan has made in this area in providing a shelter for low and moderate income people. And we look forward to Mr. Duvernay's testimony.

STATEMENT OF TERRENCE R. DUVERNAY, SECRETARY OF THE NATIONAL COUNCIL OF STATE HOUSING AGENCIES, AND EXECUTIVE DIRECTOR, MICHIGAN STATE HOUSING DEVELOPMENT AUTHORITY

Mr. DUVERNAY. Thank you very much, Mr. Chairman, and thank you, Congressman Levin. You're well aware that we look to you for leadership in the hearing, and we thank you for the support we've gotten.

Mr. Chairman, I am executive director, as the Congressman mentioned, of the Michigan State Housing Development Authority, and also, secretary of the National Council of State Housing Agencies.

I appreciate your offer to allow my full testimony to be offered for the record, and I will summarize that testimony.

My agency, among other things, administers the low income housing tax credit in Michigan. Likewise, the National Council of State Housing Agencies is comprised of, in each State, of agencies like mine. Forty-five of those agencies administer the tax credit, and those that don't are indirectly involved.

It's particularly important that I appear before you today. Because without your help, and without the help of Chairman Rostenkowski, the Tax Reform Act of 1986 would have been silent on low and moderate income housing needs.

At the outset let me make it very clear that the National Council of State Housing Agencies, and the State Housing Finance Agency strongly support the credit.

We remain equally committed to the key national housing policies enunciated in the program, particularly the depth of the targeting, the rent-to-income ratio, and the goal of economically integrated development and the use of the State administrators of this most necessary resource.

We often look back at the low income multifamily program in H.R. 3838 which you crafted, and we look back at it, and only if we could go back to that feeling. But we know that we must press ahead.

And there's a need that requires all of us to look forward, and make this program work.

From the perspective of State housing and finance agencies, the credit program will be successful when 100 percent of the credit is allocated in a given year; when the credit works effectively with tax exempt bond financing; and when the credit becomes a national program, flexible and valuable enough to work in all States.

Being responsible for administering the program in Michigan, and involved in a national association for whom the credit is a major concern has provided me with some unique insights on the program, and I'd be happy to share them with you.

To place my remarks in perspective, let me review for you my experience and the experience of State agencies with the credit in 1987.

First, 1987 was a transition year, not unlike the startup year for most new programs. The difficulties were compounded by the uncertainties following tax reform; the complexity of the program; and the lack of full Federal regulations or guidance, excluding tax exempt bond financed projects, falling under the private activity bond cap.

States were given about $317 million credit authority for 1987. Nationally, only $65 million under the $1.25 per resident statutory cap, 20 percent, was formally allocated to projects.

NCSHA is currently tabulating a survey of each State's activities. When completed next month, a detailed picture of the past year's activity can be drawn.

We will naturally share that information with the committee. Today we can make some tentative observations based on our preliminary review of approximately two-thirds of the total projects applying for or receiving a credit last year.

They are typical projects that were much smaller than developments under previous Federal programs, averaging 33 units per project, 10 units per building.

About three-fourths received some form of subsidy, the most significant being Federal, mod rehab, and Farmers Home. Some local and State assistance was also received.

The typical projects contained nearly 90 percent low income units. I know in my State the experience is much the same. Ninety-two percent of respondents chose to use the 40-60 set-aside instead of the 20-50, allowing both the higher income base and high rental income.

Less than 5 percent of the projects were nonprofits, in spite of the 10 percent statutory set-aside.

I've been asked by a number of people in recent weeks how I would judge the success of the program over the past year. First, as I mentioned earlier, last year as a startup year with all associated problems.

Second, we have taken up this program with certain expectations. The credit is one of the few incentives for low income housing production available, either on the tax or direct expenditure side of the budget. And it is ours to make work.

Because the program is capped, we anticipated that Congress intended us to fully utilize our allocation of authority. Because the program is complex, and a departure from both traditional tax-based housing incentives and direct expenditure programs for low income housing, a process of education has been necessary for all participants, ourselves, directed sponsors, and syndicators.

Having said that, I would have to say that I nonetheless look back on the past year with some disappointment. Why was only 20 percent of authority utilized? We have been placed, we think in an uncomfortable position of having to create a program without a complete set of regulations.

Through our national organization we have shared information. We've shared ideas and experience among ourselves. We made overtures to Treasury for clarification of issues that arose throughout the year.

And basically we've had to fly by the seat of our pants.

Questions arise daily for which there are no answers, due to the lack of implementing regulations. Many terms have not yet been defined, including such crucial ones as "placed in service".

For the program to work it is imperative that regulations be adopted quickly.

I would suggest, Mr. Chairman, that the process of promulgating a workable understandable set of regulations would be facilitated by the creation of a formal working group comprised of our agencies, the Treasury, HUD, and Farmers Home representatives, which could meet periodically to put the regulations on a fast track.

Moreover, recognizing your tireless efforts toward this end, I would urge prompt enactment of the technical correction package which was drafted last year.

Your hard work, and that of your staff, have resulted in a list of important provisions necessary for the success of the low income tax credit program.

We're anxious to put these measures to good use.

As important, and as desperately needed, as these steps are for regulation and the passage of technical corrections, their implementation alone will not assure full utilization of the credit authority.

Our experience to date points to some more fundamental problems with the credit which will always limit its capacity in the present form.

Development both private and nonprofit must be able to project a reasonable rate of return on a development to attract capital.

It is clear that without significant direct subsidies, the typical low income project we are seeing now is not reasonable.

Ironically, we are also faced with the fact that there are not ample subsidies of the type that once produced a low income inventory.

The reality that major direct expenditures for housing are not likely in the current budgetary environment. If we hope to see larger scale projects with an attractive income mix, development will need to be assured of certain things:

That sufficient subsidies available for each low income unit to generate the needed income stream in a mixed income project.

That a reasonable amount of equity can be raised with credit.

That if necessary, a credit project can be developed that stands substantially alone, given the fact that sufficient direct subsidies may not be readily available.

The National Council of State Housing Agencies, and my colleagues in the State housing finance agencies do not pretend to have all the answers that would result in optimal use of the credit authority. We do have some ideas and some concepts.

For example, to make this program more responsible to the practicalities of housing, you should consider allowing carry-over credit to projects that miss the December 31st deadline.

Set the applicable percentage at binding commitment. Establish a yearly applicable percentage rather than a floating rate.

Provide a reasonable time after place and service to establish eligible bases to count seasonal work not completed. Allow eligibility of rental housing developments for special needs and groups, like the handicapped, homeless and elderly, with much needed project based support services.

Redefine allocations on a project-by-project basis, rather than a building-by-building basis.

And clarify that an owner is not subject to recapture of a portion of the credit, should a person's income in a single unit of a 100 percent low income project exceed the allowable 140 percent eligible income.

To improve project income streams, you should consider such options as allowing use of the higher of State or median income; eliminating the family size adjustments in all or select instances, such as 100 percent elderly development; establishing a fair market rent by unit size; and/or allowing Federal and State housing program rental payment requirements to supersede credit requirements in Federal or State assisted buildings.

And changes to increase the value, which should be discussed, analyzed, or considered, I think should include the following:

Recognizing a higher present value to allow a higher applicable percentage; allowing the credit agency to determine the applicable percentage on a project-by-project basis; fixing the applicable percentage at a lower level, but applying it across the entire base; and allowing an additional value on the low income units.

Allowing tax exempt finance projects to use the higher percentage; and removing the provision which requires that Federal assistance be subtracted from the eligible bases.

But I would hesitate to offer any of these as the best approach or offer up a quick-fix solution just on the basis of what we now know, and expect you to risk the resources or the political energy. In the months ahead, however, we will be developing a clearer picture of what needs to be done.

The National Council of State Housing Agencies has already put in motion two major studies of the credit, one examining the projects that are being proposed and that receive allocation, the other taking a broader, deeper look at the concerns of developers and syndicators.

We want to work with you to examine some of the ongoing fundamental issues that concern, and design a program to be offered in concert with the campaign to extend the sunset. To develop the coalition necessary to be successful in that campaign, all participants—low-income advocates, the private sector, for-profit and nonprofit developers, and syndicators must be confident that the program will be fully utilized in the future.

In the interim we will work closely with Treasury in promulgating a regulation and are going to help you in any we can to achieve swift passage of the technical corrections measures.

Mr. Chairman, I appreciate the opportunity to speak to this subcommittee. This year is a pivotal year for State housing agencies. We are expending a great deal of effort to effect the passage of H.R. 2640, the extension of mortgage revenue bonds, of which you were an original cosponsor.

As you in particular understand, my colleagues and I in the State housing finance agencies are struggling to address a broad spectrum of housing needs, ranging from home ownership to the homeless. Historically, the mortgage revenue bond program has afforded us an organizational capacity which in turn has allowed us the opportunity to expand our activities.

I would be remiss if I did not thank you for your support in this area. We look forward to the opportunity to help you make the low-income tax credit an effective housing program, meeting the housing needs of many low- and moderate-income Americans.

Thank you very much.

[The statement of Mr. Duvernay follows:]

Testimony of the
National Council of State Housing Agencies
Before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives

Good Morning. Mr. Chairman and Members of the Committee, I am Terrence Duvernay, Executive Director of the Michigan State Housing Development Authority and Secretary of the National Council of State Housing Agencies (NCSHA). On behalf of the members of NCSHA, I want to thank you for this opportunity to present our views on the Low Income Housing Tax Credit (the Credit).

The National Council of State Housing Agencies represents 56 state housing finance agencies functioning in each state, as well as the District of Columbia, Puerto Rico, and the Virgin Islands. These agencies have historically played a significant role in the provision of low- and moderate- income housing and now allocate the Credit in 45 states. In the balance of the states, the housing finance agencies are involved in administering the credit by working with developers and reviewing projects. Every agency involved with allocating or administering the credit has been able to participate fully in the meetings, surveys, and other activities we have sponsored to prepare states for their role in this program.

Mr. Chairman, let me applaud you for your strong and consistent leadership in representing the housing needs of low and moderate income Americans. Without your energy, and the support of Chairman Rostenkowski, the Credit would not exist and the Tax Reform Act of 1986 would have been totally silent on the housing needs of the low income. Most importantly, since its passage you have attempted to improve it further by offering numerous improvements in H.R. 2636, the Technical Corrections Act. NCSHA has worked with you, and your tax counsel Jon Sheiner, on these amendments and advocates their immediate enactment.

On behalf of my colleague Christine Flynn, Executive Director of the State of New York Mortgage Agency and all the executive directors of the state agencies, I would also like to express our appreciation to you for assisting in NCSHA's highest priority by cosponsoring H.R. 2640, which extends the Mortgage Revenue Bond Program through 1992. I fully understand that mortgage revenue bonds are not the focus of this hearing. However, you should be aware that their loss would dramatically affect the capacity of state housing finance agencies to maintain their leadership role in providing the full spectrum of housing opportunities for our low and moderate income citizens. Ultimately, it will negatively impact our capacity to administer the Low Income Housing Tax Credit. I am sure there will be ample opportunities to discuss this issue with you and other members of the Committee in the future. I certainly look forward to it.

At the outset, let me make it very clear that NCSHA and the state housing finance agencies strongly support the Credit. We are confident that the Credit can become an effective production and preservation mechanism. To assist in achieving this outcome, my testimony will address five themes:

- the rental housing affordability crisis;
- 1987 activity;
- the numerous problems hindering effective administration of, and production with, the Credit;
- projected activity for 1988; and lastly,
- a recommended process for developing a significantly improved Credit program.

The Nation Faces An Emerging Rental Affordability Crisis

We are all too well aware of the problems facing many Americans as they attempt to secure affordable rental housing. There is in America today, a growing number of housing have-nots. In far too many cases, affordable decent housing simply does not exist. For low- and moderate-income renters, it is a problem of both increasing rental cost burdens and real rents compounded by a decreasing supply of affordable rental housing.

Since the 1940s, a 25 percent rental cost to income ratio was considered an appropriate housing cost burden. Recently, that ratio has been raised to 30 percent. Households who must pay 30 percent or more of their incomes for rent, are considered to bear a high rent burden. The incidence of high rent burden has been increasing over the past decade.

In 1983, 66 percent of all rental households were bearing a high rental cost burden, indicative of the private sector's difficulty in supplying affordable rental units. Notably, the information gathered in both 1975 and 1983 by the Census Bureau shows that the high rental cost burden is most widespread and is increasing most rapidly among very low income households. Equally discouraging is the increase in the number thus affected among low- to moderate-income households.

In addition rental property owners who saw rental increases lag behind other cost increases throughout the late 1970's and early 1980's now face the need to raise rents. As a result, William Apgar of the Joint Center for Housing Studies at Harvard University recently found in an analysis that real rents (current rents adjusted for inflation) are increasing at a rate faster than at any time in the last 20 years.

One reason so many renters are confronted with these aforementioned affordability problems is the inadequate supply of low-rent units. In 1974, the supply of low-rent units exceeded the number of households who could afford only low-rent units. A change has occurred between 1974 and 1983 in the supply and demand relationship. Over that decade, the situation reversed and a fundamental supply/demand problem emerged. When the rental units which receive some federal subsidy are removed from the market, the supply of low rent units provided by the private sector in 1983 would have been 3 million fewer than the demand. If the trend proceeds unabated, the problem will become all the more severe in the future.

The picture that emerges is one which clearly indicates a collective failure on the part of both the public and private sectors to meet the rental housing needs of low income households.

In the next month, the Joint Center for Housing Studies at Harvard will release a report on "The State of the Nation's Housing." It is our understanding that this will further describe the magnitude of the problem and verify the fact that the crisis is growing at a pace faster than our present ability to respond. In sum, the need clearly requires a stronger federal presence using both tax incentives and direct expenditures. Without question, an effective Low Income Housing Tax Credit is a key element to any array of federal assistance. The critical word above is effective and unfortunately, last year's experience suggests significant improvements will be necessary.

State Experience with the Low-Income Housing Tax Credit

From the passage of the Tax Reform Act of 1986, the state housing finance agencies have taken the Credit most seriously. Outside of tax-exempt bonds, the Credit remains as the only federal tax incentive left for the production of low- and moderate-income rental housing. In 1987, the agencies called upon the breadth of their experience as financiers and administrators of over half of the privately-owned, federally-assisted multifamily inventory to create a workable Credit program. As you would expect, the state agencies spent considerable financial and staff resources to develop sophisticated developer packets and to hold numerous public meetings for both information exchange and dissemination.

While a transition to any new program is time-consuming and difficult, I want to assure you that my agency and all of my colleagues did everything in our powers to facilitate the start-up of this program. This effort was achieved with very little guidance from the Department of Treasury and no defined programmatic guidelines. We essentially relied on each other for consultation and advice. In the end, 49 states made the subsidies available to the development community in 1987.

To establish a baseline for evaluation, NCSHA commissioned the Joint Center for Housing Studies at Harvard to undertake a review of the credit in mid-summer of last year. A report entitled, "Early Experiences with the Low Income Rental Housing Tax Credit," was released last October.

Their research found that after the first nine months' of 1987, one year after enactment:

- overall credit activity was likely to be less than one-quarter of the available authority;
- almost all projects were assisted by some other federal or state subsidy;
- the projects were predominantly 100 percent low-income;
- the projects were generally quite small, averaging 30 units, one-fifth the average size of state HFA projects pre-tax reform; and
- the projects were mostly rehabilitation and acquisition rather than new construction.

NCSHA is now in the process of gathering detailed project-by-project data from every agency administering the Credit. Today, we would like to present you with the general results of a large sampling of this data taken from approximately 900 projects. More-detailed information will be available and provided to the Committee by the end of March.

Utilization of the Volume Cap

In 1987, only $65 million, or 20.5 percent, of the total available authority under the per capita cap of $317 million allocation and $11.7 million special allocation, was allocated. For all intents and purposes, use of the Credit with tax-exempt bonds was non-existent. Experience shows economic feasibility for individual projects was so difficult to achieve that sponsors needed to obtain the maximum credit value. This was largely achieved through conventionally-financed, 100 percent low-income developments. In return, the 70 percent credit could be realized over the entire depreciable base. A 30 percent credit with tax-exempt financing, even at 100 percent low income tenancy, was not of comparable value.

Assuming quite conservatively that it was Congress' assumption that 10 percent of the private purpose tax-exempt bond cap would be used for multifamily financings, total potential credit authority would have increased by approximately $85 million. When added to the $317 million, total Credit authority available to assist low-income renters increases to $402 million. In 1987, if the Credit had been workable then and linked to tax-exempt financings, an additional $2.6 billion of low-income housing--nearly 50,000 units at an average cost of $50,000--would have been produced. Instead, actual activity with the Credit drops to 16 percent, or $65 million out of a potential of $402 million. Essentially, a minimal use of tax-exempt bond financing would have had considerable impact on the additional number of low- and moderate-income units developed with the Credit program.

On a state-by-state basis the range of credit amount allocated was dramatic. Attached is a table entitled, "Low Income Housing Tax Credit Activity", which provides rounded dollar allocations made by states in 1987. As you will note, three states used over 75 percent of their allocation, five between 50 and 75 percent, and nine between 25 and 50 percent. The remaining state agencies used Zero to 25 percent of the allocation. This wide variation can in part be explained by the character of the projects which received the Credit last year.

Characteristics of Projects Using the Credit

NCSHA is in the process of compiling the results of a survey of agencies who administer the Credit to determine what type of activity occurred in 1987. Currently, we are able to take a look at approximately 975 projects which formally applied to use the Credit in 39 states. By the end of March, we hope to have a complete picture of the 1987 projects and will make this available to the Committee.

From the sample, several general observations can be made.

- Approximately 35 percent of the projects were allocated the 70 percent present value Credit, 36 percent the 30 percent present value Credit, and 12 percent a combination of 70 and 30 percent Credits.
- Another 17 percent received no allocation, of which about 76 percent remain in the pipeline for possible allocation in 1988.
- Non-profit sponsors represented less than 5 percent of those participating.
- The sponsors almost overwhelmingly . . . by 92 percent . . . elected to use the 60 percent targeting scheme. Project sponsors were clearly interested in establishing a higher income base from which to set rents.
- Only 5 percent of the investors receiving the Credit were corporations, the remainder of the equity coming from individuals or partnerships.
- Finally, regardless of the type of Credit used, the typical project was a small one, involving buildings with an average of only 10 units and with a total project size of only 32 units.

Projects Receiving 70 Percent Present Value Credits

- Those projects receiving a 70 percent present value Credit involved conventional financing in 95 percent of the cases.
- At this time, projects that used secondary financing sources or grants from federal subsidies like HoDAGs, UDAGs and Rental Rehab or various state and local subsidies could not be distinguished, but indications strongly suggest that a large portion of projects received one or more additional form of assistance.
- Sixty percent of the projects involved substantial rehabilitation, 20 percent new construction, and 18 percent were for acquisition only.
- As would be expected, the new construction projects received a relatively greater share of the amount of Credit allocated, 40 percent.
- A significant percentage of these projects expected to use Section 8 Certificates or Vouchers.

Projects Receiving 30 Percent Present Value Credits

- Of the projects receiving a 30 percent present value Credit, almost 90 percent had a federal subsidy in the financing package.
- A larger percentage of these projects were in non-MSA areas, 40 percent, than either the 70 percent Credit or the combined 70 and 30 percent Credit projects which were heavily concentrated in MSA areas.
- Higher relative use in non-MSA areas can be attributed to the availability of the FmHA subsidy in these areas as indicated by the fact that 44 percent of the projects involved FmHA subsidy.

Projects Receiving Combined 70 and 30 Percent Credits

- Those projects receiving both a 70 percent and 30 percent Credit also relied upon federal subsidy in 87 percent of the cases and combined this almost exclusively with conventional financing.
- Forty-three percent of the projects expected to receive Section 8 Certificates and 40 percent FmHA rent subsidies.
- Of the total amount allocated to these projects, only 4.3 percent was associated with the 30 percent Credits.
- The projects involved substantial rehabilitation.

Projects Not Receiving a Credit in 1987

- Of the 17 percent of projects surveyed that were not allocated in 1987, 41 percent involved new construction.
- Seventy-three percent expected to receive some federal subsidy, predominantly FmHA.

The clear picture that emerges is one of a low volume of activity going to small projects, two-thirds of which involved acquisitions and rehabilitation. An expected start-up time for programs and delays in regulations is, in part, responsible for the small project sizes and low percentage of new construction. However, we sense there are even more serious problems inherent in the credit which will be addressed later. Federal subsidies were present in a preponderance of the projects, with the greatest portion of direct-expenditure subsidies that can as yet be identified coming from FmHA. Ironically, after a decade of budget cuts for direct-expenditure housing programs, the clear need for subsidies for Credit projects contrasts with the possibility that unless fundamental improvements are made to the Credit, direct expenditure subsidies will not be available in sufficient amounts to significantly increase Credit activity or change the character of the activity.

Problems Resulting in Low Use of the Credit in 1987

The obvious questions, Mr. Chairman, are "Why this minimal level of use and why only these types of projects?"

To some extent these results are due to the normal lag time in starting-up a new program. As mentioned above, there was little programmatic guidance from the statute. Each state had to design its own program and developers had to become familiar with the complexity of it. In addition, all the participants suffered from a lack of regulatory guidance from Treasury, guidance desperately needed to translate tax law terminology into housing terms and practices. For these reasons, allocating agencies were basically "flying blind."

We are convinced that the poor performance in 1987 is due to a host of reasons. While experience has been minimal, it has been sufficient enough to know that the program faces problems in four specific areas:

- administrative, procedural and programmatic complexities;
- incentives for developer/sponsors and syndicators;
- necessary income from rents; and,
- the actual value of the credit.

To participate in a low-income housing program, the public sector needs some flexibilty to attain the critical policy goals and the private sector--for-profit developers, non-profit sponsors and investors alike--require clear program parameters, financially sound projects and a good opportunity for a reasonable return on their investment. Without proper and careful modification, neither the public or private sector has much confidence that this program will ever achieve Congress' expectations.

We certainly do not have all the answers for you today. Instead, we have listed a number of the concerns being raised by our state agencies, organized them within the categories mentioned above and listed some potential options for consideration. It is important to emphasize that these will largely be problems and issues raised by the program's administrators. As a result, their focus will be more on the Credit's efficiency and workability, rather than its marketability or value to the corporate or individual investor.

Administrative and Procedural Problems Persist

In order to improve the administration of the Credit and to minimize many of the program's complexities, immediate attention must be given to assuring a more responsive Treasury and to enacting the amendments in the Technical Corrections Act.

Without Complete Treasury Regulations We Are "Flying Blind"

First, administration at the federal level is a significant problem hindering the program's success. Treasury must treat the Low Income Housing Tax Credit program as a higher priority. The Credit has been described by many of our agencies as an over-designed housing program being administered by a revenue-raising agency with little housing responsibility or expertise. Yet, every state agency and the program's success, is dependent upon regulations, clarifications and interpretations from the staff at Treasury. Every day new questions arise. Seldom is there a definitive answer; let alone, a timely one. One potential means of improving communications, understanding and expertise would be the formation of a working group, chaired by Treasury, to discuss Credit-related issues on a quarterly basis. Members would include staff from all appropriate federal agencies and several state housing finance agencies. NCSHA has recommended this approach several times without success. Your assistance in convincing Treasury of its merit would be most helpful.

To date, Treasury has twice issued temporary and proposed regulations. The first regulations were issued in June and clarified some of the issues of allocating agencies. NCSHA commented and testified on those regulations and included requests for guidance in several other areas. In November, Treasury issued temporary and proposed regulations regarding eligibility for the acquisition credit for projects placed in service less than ten years ago. NCSHA has commented on those and will testify at their hearing on March 17th. While helpful, these regulations touched only the tip of the iceberg. There are innumerable additional basic issues that must be addressed including the following:

- definitions of "placed in service" as it relates to various situations;
- direction on establishing utility allowances to prevent inadvertently charging more than 30 percent of an individual's income for rent;
- direction on reliable income limit schedules;
- definition of "occupancy;"

- definition of "available to the general public;"
- definition of "retirement homes providing significant services other than housing;"
- ability to use acquisition credit for projects held by a 501(c)(3) or a public agency; and
- ability to use 1988 credit for projects placed in service in 1987 for which a binding commitment was not issued in 1987 (This is an urgent issue that is especially important for New York as well as several other states).
- And the list could go on and on!

Technical Corrections Needs to be Passed

NCSHA wants to compliment you, Mr. Chairman, and other members of the Committee for the leadership it has shown throughout Technical Corrections, going beyond the non-controversial, "technical" aspects of the Credit program. It is a significant package of amendments and its enactment represents the next most logical and much-needed step to improving the Credit's effectiveness. This section will be followed by a forecast of 1988 activity. In attempting to obtain an estimate from our members, many needed to assume enactment for even an educated guess. To name a few of the major provisions that would greatly assist use of the program this year, H.R. 2636, included:

- setting of the credit percentage at binding commitment; and
- allowing federal housing program rent levels to supercede the Credit rent requirement in federally assisted projects.

The committee mark-up saw fit to add:

- carryover of authority committed to specified projects that missed the December 31 placed in service deadline;
- ability to use the higher of state or area median income;
- family size adjustments not mandatory for changes in tenant family size due to certain occurrences (House Only); and
- exceptions to the ten-year ownership rule (different in House and Senate versions . . . both versions would be beneficial).

On this latter matter, there are numerous issues affecting the Credit's viability as a tool for preserving the existing inventory of low-income multifamily developments. These will be discussed in detail at tomorrow's hearing on Preservation and Tax Policy. However, prior to any program improvements, there is a primary issue which must be addressed because of its limiting nature. It is the universe of projects eligible for the acquisition credit. The waiver of the ten-year ownership requirement should be expanded to include:

- HUD/FmHA foreclosed projects;
- federally assisted, uninsured housing finance agency financed projects;
- projects in need of funds to forestall physical deterioration, even if not in financial distress;
- developments in danger of conversion from low-income use; and
- foreclosed or vacant uninhabitable properties that would be substantially rehabilitated for low-income use.

Since Technical Corrections is being addressed, one additional point must be made. While NCSHA fully understands the need to offset revenues lost by program improvements, we would hope that some source other than a decrease in the credit cap could be found. First, we are concerned about the precedent. Second, we are confident that with improvements the Credit can realize its full potential.

Traditional Low-Income Housing Developers are Disinterested

Given success, or even significant progress, in addressing the above-mentioned problems, the result will be a more workable, easier understood and better administered program even without addressing any of the difficulties being raised by the developers to our agencies. The Credit, as presently designed does not take into account some of the normal and practical aspects of housing development; thereby, discouraging sponsors from participating. Most of our housing finance agencies had developed a very competitive multifamily development program comprised of high quality developer/builders prior to Tax Reform. One clear impact of The Tax Reform Act of 1986 was to drive from low-income housing this critical base of developer expertise. The low-income multifamily development industry mirrowed multifamily tax-exempt financings in their conspicuous absence last year. In order to begin to attract developers back to low-income housing, the Credit must respond to the difficulties inherent in producing low-income rental housing.

The following changes represent some possibilities for improvement:

- allow carry-over of the credit to projects that miss the December 31 deadline;
- set the applicable percentage at binding commitment;
- establish a yearly applicable percentage rather than a floating rate;
- provide a reasonable time after placed in service to establish eligible basis to account for seasonal work not completed;
- allow eligibility of rental housing developments for special needs groups like the handicapped, homeless, and elderly with much-needed project based supportive services;
- redefine allocations on a project-by-project basis rather than a building-by-building basis; and
- clarify that an owner is not subject to recapture a portion of the credit should a person's income in a single unit or 100 percent low-income project exceed the allowable 140 percent eligible income.

At this juncture, it is important to emphasize NCSHA's and its member agencies' long term objective---to design a Credit program which will be fully utilized in every state. It is important because it is quite likely that if all the heretofore mentioned problems were addressed, the Credit still would fall short of this goal. Earlier, structural changes were mentioned as equally necessary. The critical ones address the fundamental issue of project feasibility. Income to the projects must be enhanced if the targetting is to be achieved and the value of the credit must be increased.

Income Streams in Credit Projects are Insufficient

Most of the 1987 experience suggests that deep rent subsidies are necessary. Given the scarcity of this resource, project income streams need to be increased to a more feasible level and it can be done while still maintaining the targetting and other important policy objectives. Several options include:

- allowing use of the higher of state or median income;
- eliminating the family size adjustment, in all or select instances, such as a 100 percent elderly development;
- establishing a "fair market rent" by unit size; and/or
- allowing federal and state housing program rental payment requirements to supercede Credit requirements in federally or state assisted buildings.

The Credit has Insufficient Value

Again 1987 experience dictates that the credit is not valuable enough to induce the real estate and investment community to participate actively. The impact of Tax Reform on tax incentives for low-income housing, severe federal cutbacks in the same area and the laudable policy tenets enunciated in the Credit program, have placed a tremendous burden on the Low Income Housing Tax Credit program. It must be the primary vehicle to produce low- and moderate-income multifamily housing. To achieve this, and state agencies believe it can be done, structural changes to the value of the credit must be made to increase it. Changes which should be discussed, analyzed and considered include the following:

- recognizing a higher present value to allow a higher applicable percentage;
- allowing the credit agency to determine the applicable percentage on a project-by-project basis;
- fixing the applicable percentage at a lower level but applying it across the entire base and allowing an additional value on the low-income units;
- allowing tax exempt financed projects to use a higher percentage; and,
- removing the provision which requires that federal assistance be subtracted from the eligible basis.

As stated earlier, we do not have the answers to this fundamental issue or many others raised herein. The above is certainly not exhaustive; but, we cannot stress the importance of improving value if the Credit's potential is to ever be realized.

Prognostications for 1988

No better indication of the breadth of the problems exists than the agencies' forecast for 1988. Last month, senior program staff in each state were asked to make an estimate for 1988 based on the expectation of early additional regulations from Treasury and passage of Technical Corrections. Only 21 states felt allocations would exceed 50 percent. Of those, only 10 projected that they would reach 100 percent utilization. The typical estimate ranged from 20 percent upwards to 50 percent. Most importantly, uncertainty pervaded everyone's "guesses." It is apparent from these estimates that no Credit "pipeline" is emerging. Nor do the estimates include the potential for use of credits with tax-exempt bonds which currently would be almost impossible to guess. The specifics can be found in the previously-referenced table, "Low Income Housing Tax Credit Activity."

An Approach for Developing an Effective Credit Program

Thus far, I have attempted to set forth the need for the Low Income Housing Tax Credit and provide a detailed presentation of the Credit---its performance and problems. The picture for the immediate future does not meet the need, your expectations when originally passed or certainly our hopes. Yet, it is not so dismal as to abandon the Credit.

NCSHA strongly supports the Credit and improvements to it. We often look back at the low-income multifamily program in H.R. 3838 which you crafted with an "only if we could go back to that" feeling. But the time and the pressing need forces all of us to look forward and make this program work. As we undertake this task, NCSHA remains committed to the policy goals set forth in the Credit. The targetting, rent-to-income ratios and similar provisions must be retained and form the basis for any other decisions.

At the fear of being redundant, the goal of the state housing finance agencies is full utilization of the Credit, including a significant portion financed with tax-exempt bonds. The litany of problems require thoughtful consideration and a commitment to solving them. Mr.

Chairman, we know you are committed and we want to assure you of similar dedication on our part. Many excellent ideas and proposals will be forthcoming from today's witnesses. State agencies certainly have their share.

Obviously, some answers are self-evident and, in fact, have been addressed in amendments to the Technical Corrections Act. However, as the difficulties become more and more one of structure, designing the correct solutions become more critical, and frankly more difficult. Balance between important national tax and housing policies, Congressional control, flexibility and workability is a difficult one to strike.

For these reasons, NCSHA cannot, at this time, provide you with the design of the "next generation" Credit program which will guarantee 100 percent utilization. State agencies need more experience with the Credit. Delayed regulations and normal start-up time made 1987 an incomplete, if not unrepresentative, program year. While, we might all agree to certain improvements, the Credit must be designed in consensus with all participants . . . private and non-profit developers, syndicators, and state agencies . . . to achieve our objective.

Therefore, we are recommending that Congress create a Task Force representing the various interests. Meetings should be held on a regular basis during this year with one sole purpose . . . to design a Credit program to join the debate over sunset extension. The success of that campaign will largely be based on the level of confidence that low-income advocates and the balance of the public and private sector have that the Credit program will be a valuable tool in the future. If this can be accomplished, the Credit program will become as successful in providing rental housing opportunities for low-income Americans as any previous federal incentive.

LOW-INCOME HOUSING TAX CREDIT ACTIVITY
Estimates reported at the NCSHA Tax Credit Fly-In, February 4-5, 1988

	Authority	1987 Activity			1988 Forecast	
	1987 (millions)	Alloc. $ (millions)	Alloc. %	# Projects	Applic. $ (millions)	Est. Alloc. %
Alabama	5.00	1.600	33.00%	17	0.60	50%
Alaska	0.67	0.500	8.00%	1	0.00	20%
Arizona	4.15	0.600	14.00%	4	0.10	80%
Arkansas	2.97	0.300	11.00%	7	0.70	60%
California	33.73	5.300	16.00%	68		
Colorado	4.08	3.900	97.00%	28	0.00	100%
Connecticut	3.99	1.300	33.00%	6	1.40	100%
Delaware	0.79	0.200	20.00%	6	0.40	100%
DC	0.78	0.800	97.00%	5	0.80	100%
Florida	14.59	1.300	9.00%	18	3.50	80%
Georgia	7.63	1.500	20.00%	66	1.50	50%
Hawaii	1.33	0.000	0.00%	0	0.04	20%
Idaho	1.25	0.050	4.00%	3	0.05	80%
Illinois (homerule)	12.80	0.300	2.00%	10		
Illinois (state)	5.50	1.000	18.00%	23	0.50	50%
Indiana	6.88	0.800	12.00%	28	1.40	90%
Iowa	3.56	0.500	13.00%	13		
Kansas	3.08	2.100	68.00%	15		
Kentucky	4.66	1.900	41.00%	83	0.00	75%
Louisiana	5.63	1.400	25.00%	45	1.00	50%
Maine	1.47	0.200	14.00%	4	0.20	50%
Maryland	5.58	1.100	20.00%	22		
Massachusetts	11.17	6.200	55.00%	24	4.00	100%
Michigan	11.43	2.200	19.00%	75	0.60	75%
Minnesota	5.27	1.800	34.00%	30	0.50	40%
Mississippi	3.28	0.700	21.00%	26	0.20	75%
Missouri	6.33	1.900	30.00%	75	4.00	100%
Montana	1.02	0.600	61.00%	8		
Nebraska	2.00	0.300	17.00%	8		
Nevada	1.20	1.100	90.00%	15	0.60	100%
New Hampshire	1.28	1.900	15.00%	5	0.30	75%
New Jersey	9.59	1.400	15.00%	10	3.10	100%
New Mexico	1.85	1.000	54.00%	10	1.00	90%
New York	22.22	2.500	12.00%	41	5.60	40%
NYC	3.90	0.200	4.00%	1	7.60	100%
North Carolina	7.91	1.300	16.00%	76	0.70	50%
North Dakota	0.85	0.002	0.20%	1		
Ohio	13.44	1.800	13.00%	80		
Oklahoma	4.13	2.400	57.00%	8	1.80	40%
Oregon	3.37	0.300	10.00%	29	2.20	100%
Pennsylvania	14.86	1.300	9.00%	63	0.90	
Puerto Rico	4.09	0.000		0		
Rhode Island	1.22	0.000		0	0.01	80%
South Carolina	4.22	0.800	18.00%	19	0.80	50%
South Dakota	0.89	0.300	32.00%	11	0.30	50%
Tennessee	6.00	0.900	15.00%	44		
Texas	20.85	2.800	14.00%	78	1.00	40%
Utah	2.08	0.400	19.00%	9	0.10	
Vermont	0.68	0.100	15.00%	9	0.20	50%
Virgin Islands	0.14	0.000		0		
Virginia	7.23	0.700	10.00%	12	0.40	50%
Washington	5.58	1.500	28.00%	16		
West Virginia	2.40	0.700	27.00%	16		50%
Wisconsin	5.98	1.200	20.00%	24	3.00	75%
Wyoming	0.63	0.010	2.00%	1	0.50	50%
Total	317.21	64.962	20.48%	1,296		

* includes special authority ($3.9 million each) granted in addition to per capita authority

Chairman RANGEL. Thank you, Mr. Duvernay, and I want to thank you for the contributions you and your agency has made to get us where we are, and we look forward to your input and working together with the coalition to see whether we can make this thing really work. I want to thank you publicly.

Mr. DUVERNAY. Thank you.

Chairman RANGEL. The Chair looks forward to hearing the testimony of Mr. Biderman of New York.

STATEMENT OF ABRAHAM BIDERMAN, CHAIRMAN, NEW YORK CITY HOUSING DEVELOPMENT CORP., AND COMMISSIONER, NEW YORK CITY DEPARTMENT OF HOUSING PRESERVATION AND DEVELOPMENT, ACCOMPANIED BY JAMES YASSER, PRESIDENT, NEW YORK CITY HOUSING DEVELOPMENT CORP.

Mr. BIDERMAN. My name is Abraham Biderman, and I am the commissioner of the department of housing preservation and development; I am also the chairman of the Housing Development Corp. And with me is Jim Yasser, who is the president of the Housing Development Corp.

Before I start my formal remarks, I want to react to some of the statements that were made in the prior panel. The Federal officials who were here said they didn't see any changes necessary in this program and they felt it was fully consistent with the overall housing objectives of the administration. I would say that's probably true. The fact that they are blind to the problems that they have created in the housing market in the city is also reflected in their optimism that this credit is working as it should be. If they think there is no housing crisis, we should invite them jointly to come to New York and it will be an eye-opening experience for them.

Before I get into the housing tax credit, I want to speak to a number of issues that have been raised by some of my colleagues as well as some that have not. First of all, the mortgage revenue bonds. We, too, support the extension of that program—that's critical. But New York being unique as it is in so many respects, the housing and income limitations have to be changed for areas like New York to make the program work. We have some very successful projects, some of which I know you are personally familiar with, such as Towers in the Park, where the people who we are targeting are not eligible for Sonnie Mae mortgages because their incomes are over the limit and the project cost doesn't support people with lower incomes. We have to have some allowance for people who are going into subsidized developments, such as Towers in the Park, to be able to qualify for tax-exempt Sonnie Mae mortgages.

We also need some broader changes in the tax-exempt bond program as they are related to both general obligation bonds in general and special housing bonds. We need to eliminate some of the restrictions that were put on general obligation bonds which make it virtually impossible to finance housing construction with general obligation bonds, as well as to take housing bonds out from under the cap so that we can begin once again to use tax-exempt financing effectively as a very important resource, and a cheap one for the Treasury—but it's being stymied by some of the unintended effects of the Tax Reform Act.

With respect to the low-income tax credit, we have been utilizing that credit, or attempting to, probably in a much more significant way than any other local government, probably any other State, in the country. We have, as you know, several major programs that we have put into place with some of the national groups that are working with this credit—the Enterprise Foundation and LISC, which is the Local Initiatives Support Corp. Between these two groups and our initiatives, and working with the nonprofit sector primarily, we hope to create approximately 2,000 housing units using the low-income tax credit. I think that's probably more than any other local government.

However, that doesn't mean we think that the credit is as efficient or as effective as it should be, as I know that you wanted it to be when you originally proposed it. The truth is that in itself the credit just doesn't provide enough of an incentive to build housing, and it's only in conjunction with major subsidies by the city of New York itself that we are making these projects come together; in some cases jointly with the State of New York as well.

There are a number of specific problems which I would like to address and then offer some solutions, some of which are consistent with solutions that have been offered by some of the other members of the panel.

First, tenant incomes are too severely limited. As you know, the housing has to be occupied by people below 60 percent of median to be eligible for the credit. The numbers in New York make it impossible for us to maintain a low-income unit for less than about $300 a month. That essentially means that the people who are eligible for this credit, and the rents that we are allowed to charge pursuant to this program—means that their entire rental money must be used just to meet ongoing maintenance costs, and there are no funds available for debt service. Therefore the entire cost of construction of the unit must be paid for from other sources. There isn't enough money in the credit to do that so that unless one finds somebody who is willing to underwrite the full cost of construction of a unit, which is very high in New York—even for a rehabilitated unit, it runs about $75,000—you are left with a situation where the credit doesn't work for the incomes that people have.

Now, there are many solutions, part of which is enhancing the credit, but one of them I believe has to be, in high-cost areas, increasing the targeted population to perhaps up to 75 percent of median so that people can afford to use the credit. In New York City, a single parent making as little as $15,000 a year, would be ineligible to live in housing created under the credit.

Now, how much does the credit actually provide in the way of assistance? Originally the estimates were that on a present-value basis it would provide 70 percent. That would be not quite all we need, because we really need 100 percent—but it would be very significant. Unfortunately, we have learned from our experience in using the credit that that is not the case. By structuring our LISC and Enterprise projects, we have some very hard facts, and they do not bode well for the effectiveness of this credit on its own without some enhancements.

What we have found is that the credit essentially generates equity in a unit of about $25,000 a unit. That is about one-third of the cost of developing that unit. The way we were able to provide the additional subsidy, make the unit work, is for the city to contribute approximately $50,000.

There are a number of reasons why the credit is not as efficient or as cost-effective as it could be. One is that the credit, because of the restrictions on passive income, is essentially only available for corporations. People therefore take a credit and discount it heavily because we are marketing it to a very select group and a very small population.

It's very important, if housing is to be subsidized and assisted by the Federal Government, if not through direct subsidy, as it should be, at least through the tax credit, that the credit be then usable for everybody, so that everybody can use and that will increase its marketability. That would mean that the credit should be available without restriction for all people, to offset both passive and active income. This way the credit would not be as heavily discounted as it is being today.

We also need a credit that is deeper. The credit is set at approximately 70 percent of the present value of the construction costs. I believe we have to set the credit at 100 percent of the present value of those costs if it is going to be on its own an effective resource for creating housing.

Finally, we have to look at and have an adjustment for the differentials in costs in different parts of the country. The relationship between median income and median housing costs in New York and median construction costs in New York are such that people with median income unfortunately cannot afford housing built with median construction costs.

We are suggesting that, again, rather than be targeted to 50 percent of the median, the program be targeted to 70 percent of the area median. I know that Senator D'Amato's Advisory Panel on Affordable Housing has come with a similar recommendation.

Fourth, we have to extend the program. For something to be put in service by the end of 1989 it has to really go into construction immediately. With developers looking out and not seeing the program assured, they are losing interest, because the time frame for constructing in New York is longer than anywhere else, particularly where in addition to Federal subsidies you are also dealing with local subsidies that require extensive approval processes. We are near the point where without some knowledge that the program will be extended, no further interest in the program will be evidenced because it will be almost impossible to get units placed in service by the time frame that is called for.

In addition to which, of course, I reurge, as does everybody else, the quick passage of the technical corrections act. A very important feature of that act that is critical in New York as well, are the carry-forward provisions of the act, and the protection for owners where there is a change in the family structure of people who are already living in occupied units.

We also support expanding the credit so that it is available across the board, not just to the low-income units, but also to an entire project that has low-income in it, at a lower level, so that we can have broader economic integration in the projects that are supported by the credit. Right now the projects that we are financing through this credit through LISC and Enterprise are going to be totally aimed at people making below $20,000 a year, and we think it's better to have a program that encourages a better housing mix in terms of income.

I know that you, probably more than any other Member, are concerned about doing something for housing—and obviously it's through your efforts that we have gotten this credit through. But I think it's important that if it is going to become effective that we make it work as a self-sustaining mechanism, so that it pays 100 percent of the cost, that it become more efficient so that we don't waste any of it—because that is truly benefiting nobody—so that it covers 100 percent rather than one-third of the cost, as it does now.

I want to thank you for the opportunity. This is my first opportunity as Commissioner to testify before any congressional panel on housing. It's only fitting that it be your panel, given your strong interest. I think nobody has to tell you about the housing problems that we have certainly in New York, and this credit can be an effective tool. We need other tools. We will probably have to wait for a new administration before we get them.

But this tool is at least an interim step before we can come back to direct subsidies for housing.

Thank you very much.

[The statement of Mr. Biderman follows:]

Testimony of Abraham Biderman

Commissioner
The City of New York
Department of Housing Preservation and Development

I would like to thank Chairman Rangel and the other members of the Committee for offering me the opportunity to testify here today. While my testimony will focus on the Low Income Housing Tax Credit, I would also like to discuss some other areas within the jurisdiction of the Ways and Means Committee where your assistance is crucial if we are to be able to once again stimulate the production and preservation of decent and affordable housing.

If there is one thing we have learned in the City of New York, it is that there is no single answer to our housing problems. We need direct assistance from all levels of government -- but especially the Federal Government -- to support the construction and rehabilitation of low and moderate income housing, and we also need a tax code which will provide incentives to ensure that the private sector once again becomes involved in the production of affordable housing.

Unfortunately, the Federal Government has been retreating from its longstanding leadership role in all of these areas. Direct support for new construction and rehabilitation programs such as Section 8 and Public Housing has almost vanished. Rental subsidies have been converted from 15 year obligations to five year commitments through the introduction of the voucher program, and the bulk of the tax incentives for the production of low and moderate income housing have been eliminated with the passage of the Tax Reform Act of 1986 (TRA).

This is not to say that there have not been some positive developments which we can build on. The Low Income Housing Tax Credit can be an important component of an overall tax policy which will support increased investment in housing. And while the credit will need to be strengthened before it can be truly effective, I believe it is essential that we support its continuation. However, the tax credit is not the sole solution to our housing problems, and it must not be the only tax incentive available in our effort to solve those problems.

Cities like New York have traditionally been able to issue tax exempt, so called General Obligation, bonds for a range of "public purposes" including the development of assisted housing projects. Unfortunately, the TRA has limited the issuance of these bonds to projects which are actually governmentally owned. It is inconceivable to me that the Federal Government would not want to support localities who are willing to contribute their own funds in the form of grants or low interest loans to facilitate the production and rehabilitation of low and moderate income housing. Again, these are not luxury projects; in fact, in New York City we limit both the rents that an owner may charge and the rate of return that he may receive, in order to assure the project's long term affordability. I urge this committee to reexamine the rules and limitations on General Obligation Bonds, so that valuable projects financed with direct City contributions can once again take advantage of tax exempt borrowing.

Again, while the reinstitution of tax exempt G.O. Bonds for public purpose housing projects is essential, it is not sufficient. I also urge Congress to revive and strengthen the existing "private purpose" tax exempt bond programs for housing. The Mortgage Revenue Bond Program, for instance, has been a particularly valuable tool in raising private capital to finance loans for first time homebuyers who are purchasing modestly priced homes. However, the TRA placed a two year sunset on Mortgage Revenue Bonds, creating a feeling of uncertainty about the program. It also imposed new income limits on prospective homebuyers which have made the program extremely difficult to use in areas with high building costs and low median incomes.

In New York City for example, a family at the maximum allowable income, which has just been raised to $37,260, can only afford a home costing about $103,000. At the same time, the average purchase price for an existing home in our area is approximately $140,000. As a result, many moderate income families who could make use of the program to purchase modestly priced homes in the range of $105,000 to $125,000 will be ruled income ineligible. Even some of the families who are purchasing units in the moderate income projects subsidized by the City, such as the "Towers in the Park" project located in Harlem will be unable to qualify for low cost mortgages under the new income limits.

On the other hand, those families who do qualify will almost certainly be unable to find a home within their means. We urge the Congress to renew its commitment to homeownership by extending the MRB program as well as amending it to ensure that families who meet the eligibility standards can actually afford the homes which are available.

It is also essential that we revive the multifamily, tax exempt bond program. This program, which until recently generated thousands of units of new housing each year in the City, has now been leaden with so many burdensome restrictions that it is no longer feasible.

Obviously, those of us in government can not singlehandedly build enough housing to meet the tremendous need for shelter. The multifamily bond program has proven that it can stimulate the private sector to build low and moderate income housing in substantial numbers, but we must reexamine the current structure of this program if we are ever going to rekindle the interest of private builders through out the country. In particular, we need to remove the program from the overall cap on private purpose bonding and to amend the overly restrictive rules regarding continuing eligibility of low income tenants as well as the extremely low income levels required to qualify initially. Unfortunately I don't have time to go into these issues in more detail here today, but I have included some of the basic changes we are advocating in my written statement.

I have talked a great deal about the need to spur the production of new housing units, but it is equally important that we protect and preserve the affordable housing we already have. Much of the low cost housing in New York today was built or renovated through one of the now defunct HUD production programs, including Section 221(d)(3), Section 236, and Section 8 New Construction and Substantial Rehabilitation. Unfortunately, a good portion of this stock is now -- or soon will be -- in danger of being converted from low income housing to market rate uses, as the 20 year restrictions on mortgagee prepayment expire, and owners are allowed to "opt out" of any "use restrictions" which have applied to their property.

In New York City, we are also facing this same "opt out" issue with respect to our City and State supported Mitchell-Lama projects. In response, the Mayor and the Governor have submitted legislation which would preserve these projects as resources for moderate income families for at least another fifteen years. I know that Chairman Rangel has sponsored legislation which addresses the pressing problem of mortgage prepayment on assisted projects, and I applaud and support his initiative in this area. I believe it is important that we use the tax code to providing some sort of economic incentive for owners to continue to use their properties to serve those most in need.

I would like to spend the remainder of my time talking about the Low Income Tax Credit itself. The City of New York has labored arduously to utilize this credit to the fullest extent possible. And I believe that the programs we have developed in conjunction with the Local Initiatives Support Corporation (LISC) and the Enterprise Foundation will be among the most innovative and most successful in the country. These projects will serve to transform vacant "shells" into decent, safe, and sanitary housing for 100% low income families.

In addition, we have used the special credit allocation received by the New York City Housing Development Corporation to support a number of our assisted projects which were stalled in the development phase due to the elimination of the pre-existing tax incentives including accelerated depreciation. While the credit has not completely replaced the benefits which developers had predicated their projects on, it has enabled us to save thousands of units of valuable housing which would have been lost. Finally, we are also using the acquisition credit to raise equity for the purchase and renovation of SRO properties to be used by the homeless.

But the plain truth is; the credit is just not deep enough to stimulate low income housing by itself, and unfortunately the City cannot afford to continue contributing such an enormous portion of the total project cost.

Perhaps the biggest obstacle to developing effective projects which can utilize the new tax credit is the fact that tenants' incomes -- and consequently building revenues generated through rental charges -- are so severely limited. As you know, only housing which is occupied by families with incomes at or below 60% of median is eligible for the credit. In New York City, 60% of median income for a family of four was only recently raised to $19,400, permitting us to establish rents ranging from $300-435 a month (excluding utilities) for 1-4 person households, and this assumes that we choose to establish the maximum permissible rent. However, since most tenants in the qualified low income units would actually be somewhere below the maximum income, they would be forced to pay more than 30% of their income for rent. As a matter of policy, however, we have chosen to provide a range of affordable rents for tenants earning less than the maximum income, and therefore we have established rents lower than the amounts stated above.

At the same time, the cost of simply maintaining a low-income housing unit in New York City is approximately $300/month and that is excluding real estate tax. In short, the maximum rent allowed by credit rules is virtually the same as the minimum rent necessary just to maintain the unit. In other words, there is not much room for these projects to pay debt service on the cost of acquiring the property to be developed, let alone the cost of renovating it.

This bleak reality highlights the central problem in using a credit targeted exclusively to such low income recipients. If it is going to work all by itself - as it was originally intended to - it must generate enough equity to cover all or virtually all of the development costs.

Another inherent problem in the extremely tight income limits required by the credit program, is the fact that many truly deserving families and singles with low incomes can not qualify to live in the low income units. In New York City for instance, a family consisting of a mother and her child earning as little as $15,600 a year -- or $300 a week -- would be ineligible.

Over the past several months, we have attempted to craft credit programs which can overcome as many of the inherent problems/limitations of the credit as possible. From the very beginning of this process, it was apparent to us that the standard credit could not be "self-sufficient". In fact, even the most optimistic estimates projected that it would be worth only 70% of the development costs. And most experts expected that once syndicated, the credit would actually yield much less than the estimated 70% of development costs. As a result, we pledged to bolster the credit with a series of direct City contributions. In our LISC and Enterprise projects we:

- contribute vacant "in rem" properties of no cost,
- abate all real estate taxes for up to 32 years, and provide direct financing in the form of 1% loan for whatever portion of the construction cost was not covered by the equity contribution raised through syndication.

We have now structured our first LISC and Enterprise projects, and I am able to provide you with some hard facts about the effectiveness of the credit as a tool in raising equity. Unfortunately, these facts do not bode well for the production of affordable housing in substantial numbers.

Despite the concerted efforts of LISC and Enterprise to realize a premium price for the sale of the credit, only about $25,000 per unit (or approximately 1/3 of the total development cost) was raised. In effect, the bulk of the credit was "wasted", as investors severely discounted its value. As a result, the city was forced to contribute up to $50,000 per unit as a direct 1% loan to make these projects viable. In short, an already inadequate measure was made more inadequate.

While a number of features have contributed to the devaluation of the credit, I believe the primary reason is that it is restricted to an extremely limited range of investors. Due to the extremely tight restrictions on use of the credit by individuals, corporate purchasers have become the only real market for purchase of the credit. Unfortunately, corporations are extremely unfamiliar with low-income housing as an investment and are demanding high returns for investing in such properties.

Given the costly syndication and legal fees involved in putting these complicated transactions together, it is not surprising that very little of the cost of the low-income project can be raised by marketing the credit. And while this news is not surprising, it is certainly discouraging for those of us in City government who must struggle to raise the additional resources needed to make these projects work.

I would like to close my testimony by outlining what I believe are the necessary steps to strengthen the credit so that it can become a truly workable program. First, the amount of Tax Credit which can be allocated to a project must be increased. The credit should be deep enough to encourage developers to participate without large contributions from State and Local Governments. As a starting point, I urge the Committee to set the level of the credit to equal to 100% of the total development costs (on a present value basis) for all low income units. In addition, the credit must be flexible enough to encourage the development of mixed income projects. Our experience in the Public Housing Program and our own assisted projects has been that this mixture is often conducive to the best living environments and the long term health of the project. The current system virtually penalizes projects for attempting to bring about this balance.

Second, the Congress should ensure that the value of the credit is not lost through a devaluation on the market. In particular, the list of eligible purchasers of the Tax Credits must be expanded. Income limits for individual users of Tax Credits should be substantially raised, if not eliminated. The maximum amount of Tax Credit which an individual can claim against active income should be raised from the current limit of approximately $7,000 a year. Together, these changes would make syndications which are comprised of individuals a possibility. Since there is a cap on the amount of credit which can be conferred in each state, these adjustments would not cost the Federal Treasury any money, and they can be accomplished while still ensuring that individuals do not use the Low-Income Housing Tax Credit to avoid paying Federal income taxes.

Third, we believe that certain flexibility must be provided in determining income eligibility for high cost/low median income areas, particularly if Congress in unwilling to provide for deeper subsidies on a project basis. It is simply not feasible in New York City, where the cost of construction is 50% higher than the median national cost, to produce housing for tenants at 50% and 60% of median with out massive local subsidies. We recommend a system that allows for an upward adjustment of the maximum income limit for the low income units in those areas where construction costs are significantly higher or median incomes significantly lower. This formula would be capped so that no low income tenants could be admitted with incomes over 75% of area median. A similiar concept has been developed and explained in some detail by Senator D'Amato's Advisory Panel on Affordable Housing.

Fourth, the sunset on the Tax Credit program must be extended this year if we are to be able to begin to plan future projects relying on the Credit now. This action would have a revenue impact. However, failing to provide incentives for the production of low-income housing has a severe impact on our economic health and our national sense of well being. It is no accident that multifamily housing starts in January 1988 were at their lowest level in over five years. The dismantling of tax incentives for the production of housing has had a chilling effect on the level of development. Nor is it mere coincidence that the number of homeless Americans continues to grow, despite increased commitments by local and state governments, given the Federal Government's virtual withdrawal over the last decade from the effort to provide decent, safe and sanitary housing for all Americans.

I realize that some of these recommendations are significant changes in policy and will not be accomplished easily or quickly. However, there is much that can and should be done almost immediately. In particular, Congress must move quickly to adopt the Technical Corrections which were not included in the 1987 Tax Act. The Technical Corrections bill which was submitted last year contains a number of important provisions, but a few are worth special mention. First, the bill would allow the Credit to be "carried forward" into the next year for projects which undergo unforeseen problems and are consequently not placed in service as soon as planned. Second, the bill would provide protection for owners who currently stand to lose rental revenues when families occupying low income units decrease in size. These and other important technical corrections are addressed in more detail in the written statement submitted by the New York City Housing Development Corporation.

Again, thank you for offering me the opportunity to testify here today. I appreciate your concern for the problems we face in New York, and I hope that you will strongly consider my suggestions as you begin the process of revising and strengthening the existing incentives for the production and preservation of affordable housing.

STATEMENT OF THE NEW YORK CITY HOUSING DEVELOPMENT CORPORATION

This statement on the low-income housing credit ("low-income credit") is made on behalf of the New York City Housing Development Corporation ("HDC") by Kyllikki Kusma of Brownstein Zeidman and Schomer (Washington, D.C.). HDC serves as the housing finance agency for New York City and is involved with the development of new housing.

Behind good motives to initiate tax reform the Tax Reform Act of 1986 (the "Act") dismantled the tax incentives that had played a crucial role in the production of low-income housing. The changes to the depreciation schedules combined with the lowering of the overall tax rates, and provisions which required construction period interest and real estate taxes to be capitalized and depreciated over 27.5 years, reduced the value of tax losses critical to the production of low-income housing.

Not only did the Act eliminate most tax incentives for investment in low-income housing, it also eliminated the ability of most investors to utilize the remaining tax benefits through enactment of the "passive loss" provisions. Under the passive loss rules, tax losses generated by ownership of low-income rental housing may no longer be utilized to offset either active or portfolio income. As low-income housing does not generate "passive" income, even the reduced benefits have been rendered virtually useless.

The task and the cost of housing is one which cannot be borne by the states and localities alone. This fact clearly was recognized by the Congress in connection with the adoption of the Act in at least one respect. While the devastating impact on rental housing was clearly felt in the context of changes to the laws relating to the treatment of passive losses and the extension of depreciation with respect to rental property, the adoption of the low-income credit signaled a continuing Federal concern and commitment to housing of low-income Americans. For the low-income credit to be truly an incentive for the construction of low-income housing, certain amendments are crucial. The remainder of this statement analyzes these changes.

There are many important changes included in the Technical Corrections Act passed by the House of Representatives last year (the "House Bill") which are critical to the effective use of the low income credit. Those changes should be adopted at the earliest possible time.

LOW INCOME CREDIT

I. CARRY-OVER

A. Special Allocation

Under the Act, HDC received an allocation of additional low-income credits equal to the following amounts:

1987	$3,900,000
1988	$7,600,000
1989	$1,300,000

The absence of procedural information and the inability of housing credit agencies to make credit allocations to a project prior to the calendar year in which the project is placed in service made it impossible for HDC to allocate all of its 1987 credit apportionment. In fact, as a result of the problems associated with allocating the credit, HDC was able to allocate only $170,000 of its $3,900,000 special apportionment for 1987. Housing credit agencies may not carry forward unallocated credit authority to the following year, except in the case of authority not used in 1989. If HDC is not given special legislative relief, $3,730,000 ("excess amount") worth of low-income credits from 1987 will not be allocated to low-income projects. HDC requests special legislative relief that permits unallocated amounts from 1987 to be carried over to 1988 or 1989 as needed and to carry over to 1989 any amounts that could not be allocated in 1988. With the passage of this special legislation, developers will have an additional incentive to construct the low-income housing that New York needs.

The House Bill would have permitted the carry-over.

B. General

Section 42(h)(6)(B) of the Internal Revenue Code of 1986, as amended ("Code"), which provides that unused credit allocation cannot be carried over to any other year, must be amended. The inability to carry over credit creates uncertainty for both state housing agencies and project developers. Housing agencies have a limited amount of low-income credit which they can allocate in any one year. In making the allocation, they have several concerns: they do not want to over- or under- allocate the credit for a year and they want assurances that projects preliminarily allocated the credit are worthy and will be placed in service during the year. Because of delays inherent in any construction project, there is no assurance that a project will actually be placed in service for the year the agency contemplates allocating the credit. Planning is disrupted. Permitting carry-overs of credit will facilitate planning and insure that worthy projects are allocated, and actually receive, the low-income credit.

Planning considerations are equally applicable in the case of specific projects. The allocating agency should be permitted to carry over any credit it reserved with respect to a specific low-income project.

The House Bill would have permitted states to carryover unused credit for specified buildings, effective in 1988; but it reduces the state credit allocation from $1.25 to $1.10 per capita in 1988 and 1989. The bill passed by the Senate Finance Committee (the "Finance Committee Bill") had no legislative provision but Committee Report language (Revenue Provisions, Part 2.I.C.2.) provided guidance to Treasury in granting carryover waivers under the original Technical Corrections Bill's provisions.

II. DEEP-RENT SKEWED PROJECTS

A. Amend 3-1 Ratio

Projects that elect to satisfy stricter standards may take advantage of a special rent-skewing rule that permits incomes of current tenants to increase to a higher level than under the general rule before noncompliance is deemed to occur and looks only to the low-income units to cure noncompliance. In order to qualify for the deep-rent skewing exception the average rent charged to tenants in the rental units which are not low-income units must be at least 300% of the average rent charged to low-income tenants for comparable units. This ratio simply does not exist in most of the projects. For the deep-rent skewing rules to be more workable, the "3 to 1" market rate to low-income rent ratio must be reduced to "2 to 1." Very few, if any, projects can meet the "3 to 1" test. For projects which fail to meet the "3-1" rent-skewing requirements, the potential loss of income which would be required through the conversion of market rate apartments to low-income units would be so great as to make it impossible for owners to meet their financial obligations over time. Reducing the rent skewing ratio to "2 to 1" will eliminate this risk for such projects.

B. State or Local Assistance

Code section 142(d)(4)(B) sets forth requirements that a project must satisfy to qualify as a deep-rent skewed project. Under Code section 142(d)(4)(B)(iii), the average rent charged for units not occupied by low-income tenants ("market rate units") must be at least three times the gross rent charged for low-income units.

Some projects receive state or local assistance with respect to the entire building and they may not satisfy the 3-1 rent ratio simply because rents for all units are reduced by such state or local assistance. We do not believe that state or local governmental assistance given to a project should be a factor in determining rents for market rate units for purposes of the 3-1 rent ratio test. Instead, the test should compare the rent charged for low-income units with the rent that would be charged for the market rate units in the absence of state or local assistance.

In the absence of state or local assistance, the projects we are concerned with would have satisfied the 3-1 rent ratio test since the market rate units would have been rented at significantly increased rents in order to meet the project's debt service requirement and operating expenses. These projects should not be penalized for Federal income tax purposes merely because a state or local government provides assistance to create or preserve middle income housing along with low-income housing.

It is important to remember the context which gave rise to the rent-skewing rules. In high cost/low median income areas rents must be skewed in order to shift project costs to the market rate units and to reduce the burden on low-income tenants. When owners are required to convert market rate units into low income units at low income rents, the conversion has a severe impact on a project's economic viability. In recognition of this impact and to ensure the continued economic well-being of the project, the deep-rent skewing provisions were enacted.

These considerations are present regardless of whether a project receives state or local assistance. A project must produce enough income to meet its expenses. If a market rate unit is converted into a low-income unit, the project will receive less rents and eventually may not be able to meet its debt service and expenses. The local assistance does not mitigate this impact. The local assistance merely makes the non-low-income units in a high cost/low median income area more affordable enabling tenants other than the very wealthy to rent units in high cost areas. The tax laws should not be drafted to favor projects mixing low-income and very wealthy tenants to the detriment of those mixing low-income tenants with middle class tenants.

The language set forth below defines the term "average rent" with respect to market rate units and is, we believe, consistent with the spirit of the provisions.

> In projects which have received or are receiving financial assistance under state or local programs, the "average rent" charged to individuals not described in clause (i) or (ii) of Code section 142(d)(4)(B) shall be the actual rent charged for

such units plus the amount by which the rent would have had to be increased if there had been no such state or local assistance.

C. Section 8 Payments

Under the Section 8 program, a tenant pays 30% of his or her income, determined under the rules for Section 8, and HUD provides an additional subsidy. It is our understanding that an affirmative decision was made to exclude Section 8 payments from the calculation of gross rents under the low-income credit provisions. There is, however, an inconsistency in the statute with respect to the treatment of Section 8 payments in the calculation of gross rent. Code section 42(g)(2)(B) provides that gross rent does not include Section 8 payments for purposes of determining whether the gross rent with respect to a unit exceeds 30 percent of the income limitations applicable to the tenant occupying the unit. Conversely, Code section 42(g)(4) (by means of a cross reference to Code section 142(d)(4)(C)(ii)(1)), relating to deep-rent skewed projects, provides that Section 8 payments are included in the calculation of gross rent. There is, accordingly, within one Code subsection two methods for the calculation of gross rent.

The Section 8 payments should be excluded from the calculation of gross rent for the deep-rent skewing rules, just as they are excluded when otherwise calculating rent for the low income credit. If Section 8 payments are added to the tenant's payments to determine the gross rent of the unit, almost no Section 8 project would qualify for the deep-rent skewing rules. Moreover, the federal programs would be working at cross purposes and the deep-rent skewing rules, which are meant to enable markets such as New York City to use the low-income credit (and tax-exempt bond financing), would not provide the relief intended for those markets. Code section 42(g)(4) should be amended to eliminate this inconsistency by excepting paragraph (4)(C)(ii) from the cross reference to paragraph (4) of Code section 142(d).

III. $25,000 PASSIVE LOSS EXEMPTION

Most of the incentives favoring low-income housing were eliminated by the Act. The low-income credit provisions were enacted, in part, to provide an incentive for the continued construction and preservation of low-income housing. Historically, investors in low-income housing have been high income earners who have disposable income to invest and who can afford to make a large, illiquid investment that has substantial risks and no expectation of cash flow or near-term appreciation.

Under the Act, passive-activity losses can generally be utilized to offset only passive-activity income. An individual may, however, offset up to $25,000 of non-passive income from his rental real estate activities. The $25,000 allowance is not available, however, for wealthy taxpayers, since Code section 469(i)(3)(B) phases out the $25,000 allowance with respect to taxpayers whose adjusted gross income for the taxable year exceeds $200,000. The $200,000 limitation should be eliminated.

A $200,000 limitation essentially forecloses from investing in low-income housing the very investors who have sufficient funds for an illiquid investment and who can undertake the risk that it entails. Moreover, even if an investor has income of below $200,000 at the time of the investment, the investor would lose the ability to use the credit if later his or her income increased beyond that amount. That factor alone may dissuade potential investors.

The provision of low-income housing is a worthy social goal which will be easier met if the $200,000 limitation is eliminated to give investors willing to invest in low-income housing the opportunity to invest.

IV. SET-ASIDE REQUIREMENT

A project qualifies as a low-income project if, *inter alia*, 20 percent or more of the units are occupied by tenants whose income is 50 percent or less of area median income or 40 percent or more of the units are occupied by tenants whose income is 60 percent or less of area median income. While we understand and appreciate that relief should be targeted to serve the most needy, projects must generate enough income to enable a developer to finance the project. In areas where low median income and high construction costs combine to create burdens on housing development and operation, higher targeting is necessary to provide more income through project rents.

The Conference Agreement provides that income limits may be adjusted for areas that have unusually low family incomes or high housing costs relative to family income. The adjustments are to follow Section 8 determinations of very low-income families and area median gross income to reflect the 50 percent and 60 percent income levels. Under the authority of this section, the targetting requirements should reflect the needs of areas that have low median incomes and high construction costs.

A formula should be established to enable high cost/low area median income areas to adjust the area median income limits established by the Act. The formula should compare local costs of multifamily housing construction, land and area median incomes, with similar national costs and incomes. The current income limits (i.e., 50 percent or 60 percent of area median income) would be used as a base. In areas where the cost of construction exceeded the national average and/or where the area median income fell below the nationwide median, the income limits could be adjusted upward. Income limits would not be reduced below levels established by the Act in areas where construction costs were lower than the national average or the area median income was higher.

The proposed formula would compare area construction costs and median incomes to such national standards. The numerator of the formula would compare area costs of multifamily housing construction with nationwide costs. The denominator would compare area median incomes with the national median income. The formula is expressed below:

$$\frac{\text{area cost of multifamily construction}}{\text{national cost of multifamily construction}} \div \frac{\text{area median income}}{\text{national median income}}$$

The concept of a construction cost index that recognizes variations in local construction costs has already been proposed for hospital capital costs. The Department of Health and Human Services (HHS) engaged Dodge Data Resources, Inc. to develop the construction cost index, and it was utilized in its regulations.

Current low-income rents are barely adequate to cover maintenance and operation costs. As a result, the capital cost of construction cannot be recouped and return on that capital is merely hypothetical. Applying the proposed formula to establish income limitations would improve the ability to finance these projects and to make them economically and financially feasible.

V. GROSS RENT: STATE OR LOCAL ASSISTANCE

Code section 42(g)(2)(B) defines "gross rent" for purposes of setting forth the standards for a rent-restricted unit in a qualified low-income housing project. It specifically provides that gross rent does not include payments under Section 8 or any comparable Federal rental assistance program. It is our understanding that gross rent is not to include payments under state or local assistance programs that are comparable to the Federal Section 8 program. The Blue Book took this position but technical corrections is required to confirm this result. To provide otherwise would discriminate against those projects that have rent assistance under state or local programs rather than under the Federal Section 8 program.

VI. INCOME LIMITATIONS: FAMILY SIZE ADJUSTMENTS

Under the low-income credit rules, adjustments for family size are required in determining area median incomes. This requirement has a serious impact on the ability to underwrite projects. Underwriters need to project the rental income a project will generate to determine the amount of the mortgage loan the project can support; if the determination of available rental income cannot be determined until the project is rented (and the family size of the tenants determined), underwriters must assume all low-income units will be occupied by the smallest numbers of persons or families. Moreover, continued eligibility of units can be affected by changes in family size, if, for example, a family member dies, grows up and moves out or leaves because of a divorce.

The effect of annual recertification and required family-size adjustments is to place low-income households in annual jeopardy of eviction or substantial rent increases. Yet because of the very shortage of low- and moderate- income housing the program is designed to alleviate, in many areas with low vacancy rates, alternative housing is not available. The family-size income limit adjustments also substantially increase the risk of unintentional noncompliance for the owner.

The low-income credit rules should be amended to provide that family-size adjustments do not affect income eligibility.

The House Bill would have provided that a decrease in family size from death, divorce, separation or abandonment after initial occupancy would have no effect on the family size adjustment relative to income eligibility.

VII. SECTION 8 ASSISTANCE

Assistance payments under Section 8 require the gross rent paid by occupants of a low-income unit always to equal 30 percent of the tenant's income and therefore to increase as the income of the occupants increases. As a consequence, a low-income Section 8 tenant whose income exceeds the applicable low-income credit income standard (i.e., 50 percent or 60 percent of area median income) will be required to pay more than 30 percent of the applicable low-income credit standard as his rent contribution, a violation of the low-income credit requirements. The low-income credit rules should be amended to provide that the gross rent paid by the low-income tenant may exceed 30 percent of the applicable income limits to the extent such increase is required under the Section 8 program.

The House Bill provided that the gross rent paid by a low-income tenant may exceed 30% of the applicable income limits to the extent such increase is required under the Section 8 program.

VIII. EXTENSION OF SUNSET

The low-income credit is scheduled to expire at the end of the 1989 calendar year. The sunset date should be extended. The low-income credit rules were enacted in response to changes in laws relating to the treatment of passive losses and the extension of the depreciation period for rental property which made investment in low-income housing unattractive. With the sunset of the low-income credit, there would be no incentive left for investors to invest in housing which offers little current cash flow and limited appreciation.

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Chairman **Rangel**. Well, I want to thank you for your positive input and recommendations, and also, Mr. Yasser, and HPD generally, because they were very helpful in trying to frame what limited credits we were able to get. And I also congratulate the city, by being able to reach out to the private sector as well as to State and bring in its own resources to the table to make certain that the limited success we have with this program was possible.

As I pointed out to Mr. Johnson, these credits were never really meant to substitute a national housing policy, which we don't have, and I think all of you agree that the Tax Code should be the last place that we should be looking for a policy to provide shelter for people. And I think the depth of the problem certainly you can get from the testimony of HUD, when they are to say that there is no housing shortage. All you have to do is get the homeless to get up and go to where the farmlands have been left by those that had forfeiture of their mortgages—and I guess out there some place the poor could find housing. It's a hell of a plan, but that's what we're up against. [Laughter.]

And, like you said, we have to tolerate this lack of sensitivity until we can bring about some changes.

Mr. Biderman, to what factors do you attribute New York City's extraordinarily high construction costs? What are the major factors?

Mr. **Biderman**. Well, there are a number—and one, of course, is the very high cost of land. Land is at a premium; the city is a highly developed city obviously—there isn't a lot of vacant land. So land costs are a major factor in the high cost of housing.

Chairman **Rangel**. Suppose I just took that out. The city owns so much of the vacant land—over half, isn't it?

Mr. **Biderman**. Well, not the half of the developable land. People always come to me and say you have so much land, why don't you do something with it.

Chairman **Rangel**. Exactly.

Mr. **Biderman**. We are trying to do something with the land that we have. The program that we announced earlier this week with Mr.——

Chairman **Rangel**. No, listen, all I'm saying——

Mr. **Biderman**. But we don't own that much developable land as we think.

Chairman **Rangel**. If we could take it one by one, I'll just deal with the land that I know the city owns—the "in rem" property. So that eliminates one of the factors in construction.

What are the others?

Mr. **Biderman**. The others are—the fact that construction costs are very high in New York for, quite frankly, reasons that need some more explanation. The mayor and the Governor have both called on the Federal agencies and State agencies to investigate whether there isn't truly a free market, construction market for housing—for construction—in New York. The construction industry in New York has been in many cases weaned on luxury condominium construction, luxury office tower construction, where costs were just not a factor.

Chairman **Rangel**. You mean there could be an unlawful conspiracy?

Mr. **Biderman**. Well, certainly there have been those allegations; I'm not in a position to make those allegations without further evidence. I know that both the Governor and the mayor have urged special prosecutors to investigate the construction industry—and I am sure that is warranted, but I don't have any hard evidence to that effect, except the fact that the costs are hard to explain, quite frankly.

Chairman **Rangel**. Are we restricted to the so-called construction industry as it presently exists when we are talking about low-income housing?

Mr. **Biderman**. We are trying not to be, but the grasp of some of the unions is so strong that it is impossible to evade their grasp, particularly when you are dealing with recognized developers, which we want to deal with because of their experience, but we also have to be concerned about their ability to function on other jobs if they try to evade the unions.

We are, I believe, trying to be more efficient, and are being more efficient in terms of many of the rehabilitation jobs that are going on in the city right now. We don't have some of the featherbedding that we have on high-cost jobs in the city. But the costs are still higher than they are in surrounding jurisdictions.

As you know, concrete was one example of that. We are trying—so far unsuccessfully—to get our own concrete batching plant. Just the threat of our doing so has resulted in a dramatic drop in concrete prices in New York City.

Chairman **Rangel**. Well, how do you address the question that there are so many people in the industry, the construction industry, that are unemployed? There are so many minorities that can't even get an opportunity to join the union. The low-income housing is basically located in minority communities, and there is absolutely no strain, no fear, no problem with the community with any labor leaders at all, locally or nationally—now, given that, do you know of any attempt to bring whoever you are concerned with to the table and say we have to provide housing for these people?

Mr. **Biderman**. We do that, in fact. We meet regularly with the construction unions for a major construction management program that is now taking place in Harlem that is being managed by Tishman Construction, and we, as part of the resolution of the board of estimates approving that project, insisted on two things: one that 20 percent of the subcontracting work be given to locally based enterprises, who are essentially local small businessmen, very often minorities; and that there be a targeting of 35 percent of the people working on the site be minority or women. And we will be exceeding those targets in those areas without difficulty. And that's not a problem in most unions. There are some unions, some skilled trades, where there has been traditionally underrepresentation of minorities. That has not changed, but it is no longer a factor in most of the trades in New York City.

Chairman **Rangel**. I'm just trying to deal with the high cost, and I'm not saying that you have so much land and property that that is not a factor—but where you don't have the cost and where you don't really have the labor unions sticking to their union rates, and where you do have mandatory community involvement requirements, why the costs would not be a lot less.

Mr. **Biderman**. They are. The other factor, of course, is that we cannot afford to build in New York City, except on a limited basis, small homes—we just don't have enough land to do that.

Chairman **Rangel**. Small homes?

Mr. **Biderman**. Most of our construction is multifamily construction, high-rise construction, which is inevitably more expensive than small home construction, given the additional requirements obviously in terms of the soundness of the housing. That is another factor.

But we have a very efficient bidding system now. As you know, we have on our own, without exclusively the Federal assistance that we have for a tax credit—and there is almost no other Federal assistance—embarked on a $4 billion program to rehabilitate, build, and preserve about a quarter of a million units over the next decade—and I can tell you now that over the next month the mayor is going to be announcing additional resources to make that program even larger. We have a very rigorous bidding process in that program, and that has served to reduce costs all across the board. But New York is still a high-cost area.

Chairman **Rangel**. I know. Well, the city has really been imaginative in getting developers to assume more of a responsibility where they had larger projects to deal with low-income housing, and also to take advantage of some of our successful partnerships with the commercial sector in getting them involved in low-income housing.

Let me thank this panel. Thank you for getting us to where we are, and also in letting you know that we look forward to working with you to see whether or not we can improve, if not perfect, the provisions.

The Chair would like to announce an adjournment until 1 o'clock. At that time we intend to hear from the two final panels. And I wish I could have made that announcement earlier so that you wouldn't have to wait, but I didn't have the information available.

And so the committee stands adjourned until 1.

[Recess.]

AFTERNOON SESSION

Chairman **Rangel**. The committee will come to order. I apologize for the delay, but the White House Conference on Drugs is going on at the same time we have this conference—and I have an interest in the conference.

We will now have the panel consisting of Denis A. Blackett, president, HII Corp., Boston; Patrick Clancy, executive director, Greater Boston Community Development, Inc.; and John Johnson, executive vice president, Beacon Construction Co. from Newport News, Va.

Mr. Blackett—all of you, all of your testimony will appear in the record without objection, and you can highlight the parts that you think are most important.

Suppose we start it with Mr. Blackett.

STATEMENT OF DENIS A. BLACKETT, PRESIDENT, HII CORP., BOSTON, MASS.

Mr. BLACKETT. Thank you, Mr. Chairman. Distinguished Members of Congress, I appreciate this opportunity to testify before the committee concerning the 1986 Tax Credit Act and its effect on low- and moderate-income housing.

Before I get into the body of my testimony, let me say that it's going to be somewhat specific and unique in terms of the testimony that you have heard today. There are two unique aspects to it. One is that we last year did a lot of work on existing housing in using the tax credit law with existing housing rather than with new construction, and the other is that we work in the State of Massachusetts which turns out to have probably a very unique situation as compared with other States in the Nation.

Let me go back into the body of the testimony. You have before you a detailed chronological analysis of a hundred days of intensive effort to resyndicate, with 1987 tax credits, six existing 10-year-old projects in the State of Massachusetts. The effort was minimally successful. On December 31 we completed the resyndication of one project, and the 1987 tax credit that had been allocated to the other five projects expired.

At present the State of Massachusetts has applications for 1988 tax credit that would require three times the credit it has available. Massachusetts has $8 million in tax credits for 1988, and at present its applications would require in excess of $24 million.

Massachusetts assumes that this situation will apply to 1989 as well. It is quite conceivable, therefore, that those projects for which time ran out in 1987 will never receive tax credit.

Based on this experience, we have some recommendations to share with the committee. But before that I would like to give you some background on HII Corp. and the six projects involved.

Briefly, HII Corp. is a real estate developer with 22 years of experience in the development of low- and moderate-income housing. Most of our projects are concentrated in Massachusetts where we own over 1,600 units of housing. Overall we own and manage over 3,000 units in California, Maryland, New York, and Massachusetts.

The six projects in question totalled 950 units of low- and moderate-income housing. The greater majority of these units, over 80 percent, are large-family units with two to five bedrooms, and are located in the Roxbury-Dorchester area of Boston, a predominantly low-income black community. The majority of the properties are 50 to 80 years old; they were purchased and rehabilitated between 1971 and 1975 by our corporation.

We received notice of our award of approximately $2 million in tax credit in mid-September of 1987. Beginning immediately we contacted tenants in all six projects, and notified them of the impending equity restructuring. We conducted extensive physical surveys and financial analyses in all six projects, and determined that the projects needed in excess of $2 million to ensure their long-term viability. We met with tenants in all six projects to discuss the proposed restructuring and the proposed physical improvements. Their response was enthusiastic.

In addition, we contacted over one hundred limited partners in the different projects, and after protracted negotiations received approval in the majority of cases.

The five projects which did not receive tax credit represent some 750 families who will now not receive the benefit of this infusion of capital and whose projects' long-term viability may now be in jeopardy.

Let me go now to some specific recommendations.

One, we recommend that Congress carry over tax credit from 1987 to 1988. And we recommend that this legislation be passed immediately, since there are projects that are in limbo, having been processed in 1987, that are waiting for 1988 credit.

There would be no aggregate budget impact when one considers 1987 and 1988 together, and we believe there would be a minimum impact in 1988, since it's probable that the total tax credit involved nationwide is less than $10 million.

In the State of Massachusetts in 1987, $8 million of tax credit was available; approximately $6 million was allocated; and approximately $4½ million was used.

We believe this is a fair and equitable suggestion for the following reasons:

One, it was impossible to adequately use 1987 tax credit because insufficient time was alloted for the development of the new program. Treasury regulations outlining the manner in which the States were to allocate tax credit were not available until June of 1987, and therefore most States were not prepared to advertise for and allocate credit until August or September. The State of Massachusetts advertised for credit in late June, and allocated in early September. To this date, the States are still awaiting complete instructions from Treasury.

Two, the tax syndication industry was severely hampered in its efforts to raise money because of the stock market crash and because of the various limitations which a tax credit law put upon the traditional methods of raising equity.

Three, throughout the country utilization of this tax credit was extremely low. I believe you've heard those comments from earlier speakers. In general, the 10 largest States in the Nation utilized between 20 to 30 percent of their available tax credit, a reflection of the difficulties of working under the time constraints that the introduction of a new law provided.

A carryover 1987 tax credit would remove the unfair penalization of those projects that missed the December 31 deadline under the unusual time constraints of the initial calendar year.

We prepared a draft of what we believe is an appropriate amendment, and we will share that with the committee after this presentation.

Our second recommendation is to reduce the tax liability for existing limited partners. We recommend that legislation similar to that being proposed in H.R. 3663 be enacted. In H.R. 3663 the tax liability of the selling limited partners on existing 10-year-old projects is substantially reduced by reinstituting the depreciated project basis. From our experience it is clear that one of the major constraints to preserving existing low-income housing through tax credits is raising sufficient funds to pay some part of the tax liability of the selling partners. Most limited partners who have been in a low-income project in excess of 10 years are willing to sell if 50 to 75 percent of their tax liability is paid. However, the funds generated by public offerings or blind pools are rarely adequate to pay a significant portion of that tax liability. Therefore, the passage of what's contemplated in H.R. 3663 will be very effective in making the resyndication of existing projects feasible.

Finally, we recommend that the Congress act to broaden to syndication market for individuals. We propose that the Congress remove the $200,000 to $250,000 income restriction for individuals in the use of tax credits, as well as the $7,000 tax credit cap per individual. This recommendation is without budget impact, since it does not affect the total tax credit available.

One of the major restrictions that we found in our 3-month effort to resyndicate was the inability of the traditional syndication industry to raise funds. They were restricted in the raising of funds to dealing with individuals in the $100,000 to $250,000 category who at a maximum were purchasing $7,000 worth of tax credit per year. This lead to the use of public offerings or blind pools and eliminated the possibility of the more traditional 10- to 20-person syndication. The blind pools then faced the difficulty of raising funds in the environment that existed after the October 19 crash, so that where the industry had expected to raise over $200 million in the summer of 1987, they actually raised by the end of the year between $50 to $60 million.

In summary, we believe that if Congress allocates credits to those areas which need them and have made an effort to use them, by allowing a carryover of 1987 credit, and if Congress reduces the tax liability for selling limited partners, as H.R. 3663 envisions, and if, in addition, Congress takes steps to broaden the market for individuals, using tax credits, then both existing housing and new production will greatly benefit, and the underutilization evidenced in 1987 will not be repeated in 1988 and 1989.

Thank you.

[The statement of Mr. Blackett follows:]

WRITTEN STATEMENT OF DENIS A. BLACKETT, PRESIDENT, HII CORPORATION TESTIFYING BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES

MARCH 2, 1988

Introduction:

The following is a chronology of one hundred days of intensive effort to resyndicate with 1987 tax credits six, ten-year-old, existing projects in the state of Massachusetts. The effort was minimally successful. On December 31st we completed the resyndication of one project and the 1987 tax credit that had been allocated to the other projects expired. At present the state of Massachusetts has applications for three times the amount of available 1988 credit and assumes that this situation will also apply to 1989. It is quite conceivable, therefore, that the five projects for which time ran out in 1987 will never receive tax credit. The lessons resulting from this effort lay the foundation for legislative recommendations which seek to maintain existing stock of low income housing and achieve desired benefits for families, the elderly and the disabled.

Chronology:

1. HII Corporation is a real estate developer with 22 years of experience in the development of low and moderate income subsidized housing. Most of our units are concentrated in Massachusetts, where we own over 1,600 units. Overall we own and manage more than 3,000 units in California, Maryland, New York and Massachusetts.

2. In June of 1987 the Treasury announced its rules for allocating tax credit. In the same month the State of Massachusetts, through the Executive Office of Community Development, announced a competition for $8 million of 1987 tax credits and indicated its goals for the years '87, '88 and '89. These goals were to support existing housing in '87 and to promote new construction in '88 and '89. It also indicated that it expected to be oversubscribed for '88 and '89 credits.

3. In August of 1987 HII Corporporation submitted proposals on six projects which it had developed in the state of Massachusetts over the previous 15 years. All were financed by the Massachusetts Housing Finance Agency (MHFA). HII requested approximately $2 million to restructure the equity in these projects.

4. The six projects totalled 950 units of existing low and moderate income housing. The majority of the properties, over 700 units, are scattered site, large-family units (2-5 bedrooms) in the Roxbury-Dorchester area of Boston, a predominately low income black community. The properties are 50 to 80 years old and were purchased and rehabilitated by HII Corporation between 1971 and 1975.

5. On September 20th, or thereabouts, HII received a tax credit award for $2 million.

6. In mid-October MHFA indicated that their approval of the restructuring would be conditioned upon our commitment to keep the property low income for the remaining life of the mortgage (an additional 20 to 24 years). We agreed to the condition, although it substantially exceeded the federal tax credit requirement of 15 years.

7. Beginning in October, HII contacted tenants in all six projects and notified them of the impending equity restructuring. We conducted extensive physical surveys and financial analyses on all six projects and determined the need for a minimum infusion of $2 million to insure their long term viability. We met with the tenants in all six projects and discussed the proposed restructuring, the proposed physical improvements and the extended

commitment to low income housing. Their response was enthusiastic.

8. Beginning in October, HII contacted all existing limited partners in the six projects (over 100 individuals and their representatives, syndicators' lawyers and accountants) to determine their interest in selling the property. Negotiations were protracted and difficult, but by December 15th approval to proceed (a majority vote of the partners in each project) had been obtained for four of the projects. (One group of limited partners had declined for personal reasons, and we had achieved a 47% affirmative vote in the other case.) In all cases the amount of the tax liability for the existing limiteds upon sale and our ability to give them sufficent dollars to pay that liability was the overriding issue. Generally, the existing limiteds settled for a payment of 50 to 75 cents for each dollar of tax liability.

9. Beginning in October, HII contacted various syndicators, blind pools, corporations and other potential users of the tax credits. In October, various syndicators who had organized blind pools (at least seven blind pools in Boston, New York and Los Angeles) had high hopes of raising over $200 million industry wide for the purchase of tax credit properties. After October 19th it became apparent that the pools would actually raise under $60 million.

10. It also became apparent that the majority of the blind pools had structured their offerings for 15 year deals (not existing, life of the mortgage, 20-25 year deals) and that the equity they were raising was insufficient in most cases to satisfy both the physical and financial needs of the properties and the tax liabilties of the selling partners.

11. Throughout October and November potential corporate buyers did not materialize. This was particularly frustrating as corporate buyers can utilize both depreciation and tax credit and would have provided sufficient equity to satisfy the project needs. Because of the narrowness of the market for individuals (incomes above $200,000 are ineligible for tax credits and the total credit per individual is limited to $7,000) the traditional syndications consisting of 10 to 20 individuals were not available.

12. In late November a blind pool indicated that it would soon raise sufficient funds to buy all of our projects. They expected to be taken to market by a New York wire house in early December and to raise in excess of $40 million. Preliminary purchase agreements were signed with this blind pool.

13. By the second week in December it became clear that although sales had gone moderately well they were only going to raise between $15 and $18 million. Their senior review board now raised objections to the 20 to 25 year lockin, saying that the pool had been sold based on a 15 year lockin as the federal law requires, and that having a significant number of properties--more than 25% of their total dollar volume--committed to longer lockins would be untenable. There was also a hint of reluctance to deal with inner-city, ghetto property.

14. We then turned to a second blind pool that had expressed interest in the properties earlier. They had been trying to raise money since mid-1987 and by December had raised only $8 million, but were prepared to do at least one property. We also continued to search for corporate buyers, who could utilize both depreciation and tax credit.

15. On December 31 we closed on one property with the second pool. In the interim (the last two weeks of December) we located potential corporate buyers, but there was insufficient time to put together additional purchases and the 1987 credits on the remaining properties expired at year end.

16. In early January EOCD confirmed what it had indicated earlier: that they will likely be oversubscribed for '88 credit (at present there is 300% oversubscription) and probably for '89 credit, and that its highest priority is the production of new low income housing units. It is now quite possible that these five properties, representing over 750 families, will never receive tax credit.

17. In early January we also surveyed the 10 largest states *in the nation and discovered that the utilization of '87 credit* was extremely low--between 20% and 30%.

18. At present, the corporate contacts that were finally established in late December continue to firm up, and it is clear that if credit were available we would be able to sell to corporate buyers and to raise sufficient dollars to satisfy both the project needs and the requirements of the selling limited partners.

Lessons to be learned:

1. There was insufficient time in 1987 to adequately utilize the 1987 tax credits. Developers and agencies were hard pressed to complete all the necessary studies, tenant approvals, limited partner negotiations, etc., in the time allotted after Treasury's issuance of its regulations in June. Undoubtedly, the arbitrary December 31st cutoff prevented a number of resyndications around the country that were similar to ours. More significantly, the traditional syndication industry was severely hampered in its effort to respond in the shortened 1987 time frame:

(a) The corporate market had to be educated to the benefits of tax credits,

(b) The individual market was severely limited by the $200,000 cap on income and the $7,000 cap on credit.

(c) The October 19th crash and other Wall Street events made it difficult for the wire houses to raise funds.

2. The equity resyndication of existing projects requires more money than the equity syndication of new projects because the existing limited partners face substantial tax liabilities and these tax liabilities must be, in part or in whole, compensated for with the new money.

3. The corporate market may provide a partial answer to the issues raised above in that they can provide additional funds because they utilize both losses as well as the tax credit and that it would appear that, given time, this corporate market may mature and become active in the purchase of tax credits.

Recommendations:

1. Provide for a carryover of '87 tax credits to '88. It would be fair and without aggregate budget consequence to provide for a carryover of '87 tax credit to '88, particularly in those situations where states foresee full utilization of their '88 and '89 credits for new projects.

2. Reduce the tax liability of the selling partners through proposals such as the one contemplated in HR 3663.

3. Widen the potential market of individuals interested in buying low income housing by removing both the income limits and tax credit cap for individuals.

WRITTEN STATEMENT OF DENIS A. BLACKETT, PRESIDENT, HII CORPORATION
TESTIFYING BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES
MARCH 2, 1988

EXHIBIT A

The *following* is *a proposed* amendment to Section 42 of the Internal Revenue Code of 1986:

Subsection (h) (6) (B) is amended by adding at the end thereof the following:

> (iii) Exception Permitting Carryover of Credit Reserved In 1987. Any portion of the aggregate housing credit dollar amount of a housing credit agency for 1987 which was reserved in 1987 by the agency for an identified building but was not allocated in 1987 may be carried over to 1988 and allocated to 1987 provided that the dollar amount of such credit is within the housing credit ceiling of the agency for 1987 and provided that, prior to January 1, 1989, the taxpayer meets all of the conditions that would have been required to be satisfied to obtain the allocation in 1987 and the amount of the housing credit so allocated shall be treated for purposes of this section as a housing credit for 1987.

Chairman **Rangel**. Thank you. We will now hear from Mr. Clancy of Greater Boston Community Development.

STATEMENT OF PATRICK E. CLANCY, EXECUTIVE DIRECTOR, GREATER BOSTON COMMUNITY DEVELOPMENT, INC., AND COMMUNITY DEVELOPMENT, INC.

Mr. **Clancy**. Thank you, Mr. Chairman. I am director of Greater Boston Community Development and its affiliate, Community Development, Inc. We have developed about 5,000 units of affordable housing over the last 20 years. I'd like to briefly summarize my testimony regarding our development efforts to utilize the low-income housing tax credit and our marketing efforts utilizing the credit, and I will leave for the record comments on use of the credit in acquisition situations.

We are currently working on over two dozen projects involving over 2,000 units of housing where we are spending money on design, on development, on construction in reliance on utilizing the low-income housing tax credit. The projects vary all over the map—from rehabilitation to new construction, inner city, suburban, small town, mixed income, and all low-income—but I think we've got some observations, some descriptions, not prescriptions, from that that you might find useful.

First of all, the credit is extremely valuable. Every one of those couple of dozen projects will rely heavily on substantial utilization of the credit, and without that kind of Federal investment in the affordable housing we are working to create, we would be hard put to be doing any of those projects.

Second, the credit is necessary but not sufficient. In each one of those projects we are utilizing additional State, local, and, in many instances, Federal resources that generally exceed themselves the subsidizing value of the credit. So if the credit is worth x dollars a unit, we have got another $2x$ a unit in additional subsidies to make the housing that we are working to create affordable.

So the credit is important, it's valuable, it's necessary, but not sufficient.

Third, the credits make many of our housing efforts more complex. In many inner city neighborhoods, small towns, and even with many low-income community-based organizations, the desire to have some mixture of incomes among the people that are served in new or rehabilitated housing created in a community, is real and substantial and often one that's politically necessary.

What we end up doing in that situation is very complex. We utilize the credit on low-income units that are in a rental form. We utilize the value of the homeowner deductions for upper income people in units that are done in condominium form. Two things happen from that. No. 1, the moderate income fall out because they are not in a tax position to take advantage of the homeowner deductions, and they don't get the credits. So we need to raise more other subsidy funds to be able to serve them. And, No. 2, we've got one development venture that now has two whole ownership and financing structures, which is immensely complicated. We are doing it, but it's an immensely complicated way to do business.

Four—and this is, I hope not because the light is about to go to orange—time's up. As we sit here today, as we think about going out and finding a site, developing a development concept, putting together plans, putting together the other sources of subsidy, getting financing, getting local approvals, and getting into the ground, the fact that the credit runs out if you are not in the ground and in construction in 1989 means, quite frankly, that if you start today you are not very likely to make it in the kind of complex financing and development effort that is currently necessary.

So extension is critically important now if we are going to maintain the limited momentum that has been built up in utilization of the credit.

Clearly, as you, Mr. Chairman, pointed out at the beginning of this hearing, what's going on with the credit is a very modest overall level of activity nationwide and the absence of a much larger array of direct Federal involvement in direct subsidies dealing with the housing problem is a major contribution to the gross inadequacy of current affordable housing efforts.

I think—and I've done a lengthier paper that was presented to the Senate Housing and Urban Affairs Subcommittee, laying out in some detail why—that the credit specifically—and investment incentives through the Tax Code more generally—are an important part of an overall Federal housing effort and should be maintained. I think some of the issues that you have heard today that are pointed out in greater length in my statement and in that paper that need to be addressed in the redesign of the credit should be looked at in conjunction with looking at a larger Federal role in direct assistance and financing. And one of the critical things that I think is happening at this juncture for the first time in my 20 years in this business is that the discussions that are going on between tax and housing committees and staff provide the potential for the critically important tying together of those resources, as we create a new Federal effort for the future.

In terms of marketing of developments using the credit to investors we are doing that entirely to corporations. We've had a $16 million offering with corporate leadership in the city of Boston, which has been completed. We've got a $12 million offering which is being completed this month through an investment banking house going to corporations. We've got a $9 million offering involving several development projects which we are negotiating directly with a small number of corporations and expect to complete in the next couple of months. We have substantially more than that on our plate for this year, but from the early efforts I would like to share a few comments on the marketing issues.

It's a very tough market to find corporate investors. For corporations who don't know real estate, it's very hard to get them to know it. For corporations who are sensitive to their image, who want to do something that's kind of a good-guy activity, but are afraid of ending up with some poor folk appearing on the doorstep in ten years if something goes wrong, you just can't get them over the threshold. And for corporations who understand and want a real estate investment, offering them a real estate investment that is not really a real estate investment, because you don't want to sell them residual value and appreciated real estate and create an expiring use problem in fifteen years, those corporations aren't interested either.

In addition, the individual market, for reasons you've heard, is far too restrictive and inefficient to be useful in the way in which it's now designed. So I think the kind of legislation that Senator Mitchell referred to this morning that exempts low-income credit developments from the passive loss rules and reopens the upper income individual market is critical if the credit is to really work for any kind of significantly expanded use.

I'd like to mention one specific coordination issue, and ask the committee's assistance in coordinating with the banking committees and with the Federal Reserve Board. The Federal Reserve Board has rules for bank holding companies that are in the process of being formed and is increasingly requiring that they not make or be severely limited in making real estate equity investments. The largest corporate market that we have found interested in participating in these tax credit investments has been financial institutions, many of whom are affected by those Federal Reserve Board regulations. For those institutions not to be able to purchase because of Federal Reserve concerns with equity investments in real estate, along the lines of some of the things that have occurred in the southwest over the last several years, is an inappropriate restriction. Some exception for low-income housing credit investment could really help us to continue to get as much out of the corporate market as possible.

Thank you.

[The statement of Mr. Clancy follows:]

STATEMENT OF PATRICK E. CLANCY, EXECUTIVE DIRECTOR, GREATER BOSTON COMMUNITY DEVELOPMENT, INC.

Mr. Chairman, Members of the Committee. My name is Patrick E. Clancy. I am submitting this statement to you as the Executive Director of Greater Boston Community Development, Inc. (GBCD) and its affiliate, Community Development, Inc. (CDI). These organizations are non-profit corporations providing a full range of real estate services - development, financing and management - to local communities throughout Massachusetts and, more recently, Rhode Island and Connecticut for the production and operation of housing for households of limited means. Over the past 20 years, these organizations have assisted in the creation of approximately 5,000 units of affordable housing utilizing a wide array of debt, subsidy and equity financing totaling in excess of $220,000,000.

As you well know, the low income housing tax credit was created as a part of the massive tax reform effort in 1986 when very limited time and attention were available to complete a fundamental revamping of the tax code. I'd like to express my appreciation to the Subcommittee for the chance to appear here today and to participate in your important effort to reflect on how that vehicle has worked and on what if any changes may be necessary to ensure its greatest possible efficiency and utility.

I will share our experience in developing housing utilizing the credit, in marketing investments in tax credit developments and in utilizing the credit to finance acquisitions of existing developments. I have also had the opportunity to analyze in greater detail the role of investment incentives provided through tax provisions, including the credit, and their relationship to federal housing programs in a paper I prepared for presentation to the Senate Housing and Urban Affairs Subcommittee last fall. I've also provided copies of that paper with my testimony for Committee members and staff.

A. Development Efforts. My organization is currently working on over two dozen development projects - totaling in excess of 2,000 dwelling units - where we are expending significant funds based in part on planned utilization of the low income housing tax credit. These developments are quite varied - new construction and rehabilitation; utilizing tax-exempt bond financing and taxable mortgage financing; all low income and mixed income. I'd like to make a series of observations from this varied experience.

1. The low income housing tax credit is an extremely valuable resource for producing new housing units serving low income households. With the substantial percentages of project costs that can be claimed as credits, with the additional benefit of losses to corporate investors, and with the kind of net proceeds available when marketing these benefits, as described below, the low income housing tax credit has very quickly become an absolutely critical tool in our work. It represents a significant and crucial federal involvement in virtually all the new affordable housing we are producing.

2. The credit is itself totally inadequate as a sole source of assistance for producing affordable housing in our experience in the Northeast. Every single one of the more than two dozen projects on which we are at work involves several other sources of subsidy. In every instance a substantial array involving some combination of state assistance, local assistance, and additional federal assistance is essential to meeting the cost demands of rehabilitation or new construction and operation while achieving the affordability levels required by the credit. It is generally the case that, beyond the credit, several elements of additional assistance are necessary in amounts whose overall value is in excess of the value of the investment incentive provided by the credit.

3. One of the major shifts in our development efforts created by the targeting requirements of the credit - which generally I support as focusing incentives on the housing that serves those with the greatest need - is a very complex dynamic in the development of housing to serve those of low income in the cases where we are seeking in addition to serve households of moderate income and, in some instances, to provide market rate housing units as well. In this work, we find low income credit eligible units well supported through the credit as an investment incentive; market rate units needing to be designed as ownership housing to get the value available from real estate interest and tax deductions; and units for moderate income households in many ways the most difficult to finance given the lack of value of homeowner deductions and the lack of any other incentives supporting their development. The complexity of combining different ownership structures is enormous but necessitated by the current tax treatment.

4. Developing housing utilizing the low income housing tax credit involves very large timing risks currently for two reason. First, without an extension of the credit's sunset provisions, preliminary activity on new projects for which other subsidy funding must be sought and secured, construction documents, local approvals and financing commitments realized, credit allocations achieved and construction begun before the end of 1989, is already at substantial risk of not meeting those timing limitations. Secondly, even beyond this timing constraint, the general risk of securing a credit allocation is now added to the risk of achieving various other subsidy resources necessary, further reducing the odds of success to the point where few for-profit actors are likely to undertake substantial activity in the face of these compound risks.

These observations, together with the dramatically reduced direct federal support for affordable housing development today, make it obvious why the total affordable housing production effort nationwide today is scandalously small. If there is to be any serious increase in these housing efforts, a number of the limitations and complications of currently available resources, including the low income housing tax credit, will have to be significantly improved upon.

The suggestions that I would make based upon this development experience are as follows:

1. Passage of the refinements to the credit contained in the Technical Corrections Act of 1987 is important to respond to several of the most problematic restrictions and complications affecting utilization of the credit.

2. It is critical, in maintaining the modest momentum which has been achieved in tax credit production, that the credit be extended for at least an additional year in the very near future.

3. Over the next year, it is important to consider substantial changes to the credit to simplify it and make possible more substantial utilization. It is particularly important that this effort be done in conjunction with the work of congressional housing committees to plan potential expansion of direct federal housing support for affordable housing production. These changes should include broader allowance for use of the credit with the full range of federal, state and local assistance; further modifications to the "cap" on use of the credit; design of modifications that can make production of mixed income housing - particularly housing that serves moderate income as well as low income households - more viable; and consideration of measures to ensure the longer term affordability of credit units beyond the current 15 year framework. Many of these elements are

discussed in further detail in my paper provided with this testimony.

B. Marketing Tax Credit Developments. Since the passage of the Tax Reform Act of 1986, we have actively participated in the structuring, packaging and marketing of equity investments in developments utilizing the credit. In 1987, a $16 million offering we prepared was completed for the substantial rehabilitation of 950 units in a series of properties in Boston. These properties are being acquired through HUD's Property Disposition program, are financed through the Massachusetts Housing Finance Agency (MHFA) and will receive Section 8 subsidies. The investment was placed with corporations, through an active corporate leadership process. A second, $12 million offering, for five Massachusetts new construction and substantial rehabilitation projects is being completed this month. These projects will receive MHFA financing and an array of state assistance. The placement effort has been undertaken by a major investment banking house as an institutional placement with certain corporations. Additional 1988 offerings on tax credit developments include a $9 million dollar investment in several Rhode Island developments we are currently arranging directly with corporate investors.

Although our corporate marketing efforts are achieving some success, the effort and energy required to reach a corporate market with tax credit investments in our experience is a serious cause of concern. Marketing efforts with an array of manufacturing, publishing and high technology corporations have seen only limited success. We've found it difficult to overcome the hesitation regarding involvement in a new socially sensitive investment area - with potential public repercussions should problems be encountered - as well as resistance to an investment in real estate offering essentially fixed returns and no significant likely equity appreciation. We've experienced more marketing success in marketing to financial institutions, most of whom have some significant familiarity with real estate and housing through mortgage lending or other financing or investment activities, and many of whom have a desire to re-invest in their local communities and requirements to do so under Community Reinvestment Act.

To provide some sense of the pricing and efficiency of tax credit marketing, I'd like to compare the impact on housing feasibility of one dollar of rent subsidy funds available for 10 years and the value of one dollar of tax credits available for each of 10 years. First, one dollar of rent subsidy, if used to amortize a 10-year mortgage at 11% interest rate, can support $5.50 of additional capital. For every dollar of tax credit each year for 10 years, we have been able to raise in the neighborhood of $5 which provides, net of transactions costs, a present value to the development of approximately $4.30. Thus, although the tax credit dollars are a somewhat less economic incentive than direct subsidies, their value is commensurate with the general parameters that hold equity investments to be greater risks and to require greater returns than debt. Our tax credit marketing has generally been structured to provide rates of returns to investors in the 15% to 20% range.

We have not undertaken any efforts to market investments in developments utilizing the low income housing credit to individuals for two reasons. First, there are still a significant portion of the benefits available from tax credit investments that result from tax deductions provided due to depreciation and interest and other expenses. These deductions are not useable by individuals unless they have passive income which can be offset by them. In general, there is not at this time a market of significant numbers of individuals who have passive income and losses to whom theses investments could be marketed. Secondly, the need to market credits only in small investments and only to individual investors whose income is virtually assured of not exceeding $200,000 over a 10 year period represents in our opinion an expensive and highly inefficient approach.

We believe quite clearly from our experience that any expanded utilization of the low income housing tax credit will be thwarted - given the limitations described above of the corporate market and the individual market - unless the credit is made available in larger amounts to higher income individuals. I would urge the Subcommittee to seriously consider ways of opening up that market for the sake of the low income households who stand to benefit from housing which utilizes the credit.

We have also encountered a significant marketing issues as a result of existing and proposed Federal Reserve Board regulations. In the first syndication offerings marketed to corporations, we and others have found that one of the strongest market segments have been savings banks, which have acquired significant proportions of the corporate equity offerings to date. This kind of investment is particularly beneficial from the federal policy perspective, in that it simultaneously meets two federal policy objectives - the primary use of the Low Income Housing Tax Credit by corporate investors as dictated by the Tax Reform Act of 1986, and investment by banks in valuable community projects as called for in the Community Reinvestment Act. However, the Federal Reserve Board restricts real estate investments by banks in the process of approving the formation of bank holding companies. Furthermore, proposed FRB restrictions (as described in Docket #4-0537) would impose additional limits and, if applied retroactively, could force divestment of credit-based investments. This could impose severe credit recapture penalties, and it has already foreclosed investments by certain banks which would have otherwise invested in credit-based programs. I would like to urge the assistance of this Subcommittee in bringing this matter to the attention of the appropriate banking subcommittee so that fair consideration of tax and housing policies can be introduced to ensure that the strongest corporate market to-date can continue to be utilized.

C. Acquisition. We have also acquired a 430 unit HUD insured development utilizing 1987 tax credits that we are currently structuring for corporate placement. From our work in structuring this acquisition and financing, we'd like to offer some observations on potential use of the low income housing tax credit as an incentive for the maintaining of housing that serves low income people.

1. One of the most significant elements in determining the viability of the continued use of older federally assisted properties as housing for low income households will be the extent to which the federal government is prepared to continue to provide rental assistance to these developments. Without extension of the direct rental assistance provided to low income households in so many of these developments, their affordability by low income people will not be assured and the potential for utilization of the low income housing tax credit will not exist. Thus, consideration of tax credit utilization on these properties must be combined with the design of continued federal rental assistance of the type which has now been mandated in the Housing and Community Development Act of 1987, but which has not at this point been funded.

2. There is substantial potential for effective use of the low income housing credit to deal with the problem of the so-called "expiring use restriction" properties. The value of the credit is a function of two things: the percentage of units occupied by low income households and the cost of the property. In acquisition of expiring use properties, the cost is directly based upon the value of the property. Thus, it is precisely where one would hope from the policy perspective that the credit would be of most use - where there is a high percentage of low income households and a high market value and thus a large potential for substantial displacement - where the credit will be of the most value and can be a most valuable tool.

It is important to note, however, that the dimensions of the expiring use problem are so overwhelming that we must all be careful to ensure that investment incentives are not disproportionately utilized only on existing properties at the expense of the crucial continuing and expanded production of new and rehabilitated housing to serve low income households.

A number of areas of clarification to the credit provisions have been left to the promulgation of detailed regulations by the IRS. Here it is essential for Congress to provide continued oversight and direction, so that such regulations will conform to the intent of the original legislation. One example of a potential problem area of which the author is aware relates to current discussion of requirements that apartments eligible for credits be made available to the "general public". Conversations with IRS staff members have suggested that this is to be defined so as to preclude credit eligibility for projects developed for special needs populations such as the elderly, the handicapped, and others requiring special services. Because such populations are often the most disadvantaged with respect to housing needs, projects oriented to their specific needs should remain eligible for credits. Similar language has appeared in the tax code for a number of years with respect to tax exempt bond financed activity and the interpretations there have allowed for specialized projects for particularly needy populations. A similar approach should be taken with respect to the credit.

I've tried to summarize for the Subcommittee some of our experiences in working to utilize the low income housing tax credit and to preliminarily suggest some of the lessons from this experience. I'd be happy to continue to work with the Subcommittee and staff as your efforts to ensure maximum public benefit from utilization of the low income tax credit continue. Thank you very much.

Chairman RANGEL. Thank you, Mr. Clancy, and I will ask staff to look into that suggestion.

Mr. Johnson.

STATEMENT OF A.J. JOHNSON, EXECUTIVE VICE PRESIDENT, BEACON CONSTRUCTION CO., NEWPORT NEWS, VA

Mr. A.J. JOHNSON. Thank you, Mr. Chairman. Although I'm testifying as an individual, I am also the treasurer of the Council for Rural Housing and Development, which has 200 developer and financier members, mostly in the development of section 515 Farmers Home rental housing. I've also been authorized to speak on their behalf.

My primary purpose for being here is to urge continuation of the tax credit program and to eliminate the sunset provision. This has been addressed by Mr. Clancy, it's been addressed by some others. But this is an absolutely crucial element of the future success of the program. And, as has already been alluded to, anything that we begin developing in my company after this June is really speculative in terms of being able to complete the development phases and get under construction in time to utilize the tax credit before the end of 1989. So really we are beginning to push the sides of that envelope in terms of taking risks which may be unacceptable to developers.

The program has been very successful—I can speak on a personal standpoint for that. We have used it primarily in conjunction with Farmers Home section 515 housing. Even with the Farmers Home interest credit, which Vance Clark spoke to earlier today, it is the tax credit itself which provides the incentive for developers to proceed with the rural rental housing. It is the interest credit which makes it work, but the tax credit which makes it go.

This program is a perfect example of a partnership between our Tax Code and our housing policies, I think which can serve as an example for any future codes and future policies which we may develop in terms of how to develop that sort of partnership to create the incentives necessary in order to develop the housing for our lowest incomes.

The best part about the program is that it's targeted—and for that reason may be the best overall tax incentive program for low-income housing ever created. And by "targeted," I mean unlike previous tax benefits, as a result of low-income housing, this benefit results only when a low-income family is directly assisted. In the old accelerated cost recovery system and previous tax benefit systems, a certain percentage of low income had to be assisted in order to gain the benefits. With the tax credit, the benefits are on a direct unit-to-unit basis, so without assistance to low income there is no tax benefit to the developer or the owner.

The credit itself does spur the production of low-income housing. We realized that a philosophical concern of legislators may be whether or not a tax credit is necessary in fact to help produce low-income housing. And I don't have to tell you or anybody on this committee that there are three basic reasons for investing in rental housing: cash flow, appreciation or the possibilities of future growth, and tax benefit.

Well, with Government-regulated low-income housing, cash flow is limited. We are going all through the prepayment issue, so we know the issue of prepaying on loans and looking at future growth. So essentially that brings us down to tax benefits, which are the only major factor as an incentive in the development of low-income housing for developers.

And we have to address whether or not the actual needs as they exist today justify the cost of this tax credit program. We have currently in the country 1 million families on subsidized waiting lists. This, as an individual developer, is a number I have trouble conceiving of, but in my own case we have 779 subsidized housing units currently. I have 1,063 people on the waiting list for that housing. Based on our rate of turnover, these people will wait 4½ years before I can house them. Nationwide we have an additional 12 million poverty-level families needing housing assistance. Some of you being from Washington may be familiar with Virginia Beach, which is a fairly well-known nearby tourist area. There are 200 outhouses in Virginia Beach. You don't see them when you go to the beach, but they are there. In northern Virginia you need an income of $35,000 a year to be able to afford your average two-bedroom apartment—that's $17 an hour. We have to wonder what the $8-an-hour worker does. We know a lot of them sit on waiting lists, hoping that one day they will get a chance to have a decent place to live.

And then we have our hidden shame in Virginia, which is our rural housing problems. No bathrooms, lack of insulation, lack of heat. These conditions are real, they exist now. A Sunday drive on any of our State's back roads will clearly show you the extent of this condition.

I think, Chairman Rangel, that you could probably identify it with the conditions that exist within your own district. Within the rural areas of Virginia you will see the same conditions—they are just more spread out.

So we believe that the need does justify the cost, and that is assuming that we believe that families have the right to expect the opportunity for some decent housing. And I think that a compassionate nation has to find a way to decently house its poor, and this is certainly a step in the right direction.

The credit itself is very effective. As I said, we have seen it work. We have developed to date four low-income housing credit projects with a total of 151 units; we have another 16 in development. It may not be a large number, but each one of those is rented to a low-income resident. All are Farmers Home section 515. The income averages range from $10,830 a year to $15,690 a year. This, by the way, is less than the average tenant incomes for Farm Home projects we developed previously under the old ACRS system. The credit works because it's valuable to investors. They will pay a fee to developers in return for that credit.

I've included in my written testimony a complete example of the economics of how the credit works for a developer.

Although we are basically pleased with the program, there are some suggested ways it could be improved. Many of those have been discussed earlier, so I will be very brief on those.

First we encourage you to speedily adopt the technical corrections bill, which will make the program more feasible in low-income areas by going to State median incomes as opposed to the lower rural incomes.

We also request that that technical corrections bill be approved quickly to help reconcile the requirements of the tax credit provision with the problems that occur when section 8 subsidy is available on a complex.

We would also suggest adding a third income test for qualification, and that would be to add, in addition to our 20/50 and 40/60 standard, a 60/80 standard, where 60 percent of the units had to be occupied by people at 80 percent of median income. This again would be a method of assisting those very-low-income rural counties and the states with low median incomes.

We would also suggest using a sliding scale of credit percentages to encourage the lowest income occupancy possible. And here, for example, the 20/50 standard could use a 5- or 10-percent credit, the 40/60 standard a 4-percent or 9-percent credit, and if the 60/80 standard were used, then a 3- or 8-percent credit could be used.

And we would also urge you to eliminate the cap on investor income while retaining the $7,000 limit on use. This would broaden the market of investors, especially for upwardly mobile individuals who now fear possible future tax liabilities if they use the credit.

In closing, I'd like to commend you, Chairman Rangel, for holding these hearings, and also for your well-known concern about our rural housing situation, even though that's not your specific constituency. And to let you know that the Council for Rural Housing Development is prepared to work with you and your staff in any way in making this low-income housing credit program much more workable.

I'd like to thank you, and I'd be happy to answer any questions.

[The statement of Mr. A.J. Johnson follows:]

TESTIMONY OF A.J. JOHNSON

Before Subcommittee on Select Revenue Measures
Committee of Ways and Means
House of Representatives

March 2, 1988

My name is A.J. Johnson. I am the Executive Vice President of Beacon Construction Company, Newport News, Virginia. I am testifying in my individual capacity, although I serve as Treasurer of the Council for Rural Housing and Development, an organization of over 230 developers and financiers of projects under the Farmers Home Section 515 program and am authorized to say that the recommendations in my testimony reflect those of the Council.

Continue the Tax Credit Program

For reasons spelled out in depth in my testimony, I believe the tax credit program has been a successful one, especially in rural areas where it can be combined with the Farmers Home Section 515 interest subsidy program. As stressed later in my testimony, the Section 515 subsidy alone would not induce development of rural housing as the benefit of the 1% interest rate is passed entirely through to the tenant. It is the tax incentives through the credit that impell the developer to participate in the program and that is why it is essential that the program continue. So first, we urge that Congress eliminate the 1989 sunset provision on the credit and make it a permanent program. For the reasons so well set forth in the testimony of Stephen Ross, in 1988 at the least Congress should extend the sunset date by one year pending permanent action to be taken in 1989.

The Program is Highly Targeted

Now let us examine in depth why Congress has the opportunity to preserve what may be the best overall tax incentive yet developed for low-income housing. By best, I refer to the fact that the low income housing credit (LIHC) is the first low-income housing tax program linked directly to occupancy by low-income families on a unit by unit basis.

Prior to implementation of the LIHC (January, 1987) primary tax benefits for low-income housing were achieved through the use of the Accelerated Cost Recovery System (ACRS). This rapid form of depreciation allowed developers of low-income housing to "write-off" the cost of improvements for a low-income project in 15 years, on a "double declining balance" basis. This method allowed very high deductions in a project's early years.

From an investor's point of view, the ACRS method had another major advantage. To qualify as low-income, a resident only had to have an income at or below 80% of the area median income; only 20% of a project's units had to be occupied by low-income residents in order to qualify for ACRS treatment. As long as a developer accepted some limit on return and a cap on rents, it was possible to develop an apartment complex where 80% of the residents were not low-income and still enjoy full benefits of a low-income development.

Unlike ACRS, the LIHC may only be claimed on a rental unit which is actually occupied by a low-income resident. It is a "people" based tax benefit, as opposed to a "project" based benefit. An example will clarify how this difference works.

Example: Assume a 100 unit rental complex with a depreciable basis of $3.7 million. The developer intends to designate 20 units for low-income occupancy. Under ACRS, the owner would be entitled to full, 15-year depreciation benefits on the entire 100 units. Using the declining balance method of depreciation, the first year deduction would be $493,333. Assuming today's 28% tax bracket, tax savings would amount to $138,133.

Under LIHC, the 20 low-income units (20% of the project) would have to be occupied by families with incomes at or below 50% of median (the 20/50 test). The 20 units under ACRS would have to rent to families at 80% or less of median. Also under LIHC, tax credits could only be taken for the 20 units actually occupied by low-income residents. The remaining 80 apartments receive no special tax consideration. With the $3.7 million basis, each unit has a basis of $37,000. If the project were conventionally financed and the 9% credit were used, each unit would be entitled to $3,330 annually in credits for 10 years. The annual credit for the 20 units would be $66,000. If the project had tax-exempt or other federally assisted financing, the 4% credit would be $29,600 per year. Both are obviously much less than the first year ACRS benefits. Carrying the two methods forward to their end result shows that under ACRS, total 15 year tax benefit would be $1,036,000. Using a 9% LIHC provides 10 year tax relief of $666,000, while the 4% LIHC allows credits of $296,000 over 10 years.

In short, the LIHC program would cost the federal government from $370,000 to $740,000 less in lost tax revenue than ACRS, while providing housing for lower-income families than required under ACRS. Tax benefits to the LIHC project only increase if the actual number of low-income tenants increases.

It is also worth noting that the LIHC program is the only tax-benefit program which gives developers an incentive to provide private subsidies to low-income families. This happens due to the fact that under LIHC, the maximum gross rent a tenant can pay is 30% of the maximum eligible income, by family size. If a project's economic gross rent (the rent required to operate the project and pay off the mortgage) is higher than the 30% level, as is often the case in Farmers Home Section 515 projects, the developer must pay the difference between the two rent levels, if he wants the tax credit. This is, in effect, a tenant subsidy paid by the owner. If the difference between the two rent levels is not excessive, the value of the tax credit is such that it is worthwhile to the developer to provide the subsidy. My own company has structured a project in exactly this manner on the Eastern Shore of Virginia, in which we return approximately $800 per month to residents in order to qualify for the tax credits.

Credit as Necessary Spur to Low Income Production

A major philosophical concern of legislators may well be whether or not a low-income housing tax credit is necessary to spur production of affordable rental housing. The best way to address this question is a brief look at the reasons, or incentives, for developing rental housing.

Historically, there have been three basic reasons for investing in rental housing. Those are (1) cash flow or return on investment; (2) appreciation in property value; and (3) tax benefits.

Due to the limited return of cash in low-income housing (because of government regulation), cash flow is not generally an incentive for developing affordable rental housing. Likewise, government requirements to maintain low-income housing status for a long period of years are a major inhibition against investing in such housing for its growth potential. This essentially leaves tax benefits as the only effective incentive for investment in low-income housing. Simply put, without tax benefits of a significant nature, the development of affordable rental housing will come to a virtual halt.

Understanding that tax benefits are necessary to the development of low-income housing does not address the essentially political question of whether or not the cost involved in providing tax benefits for such housing is justified by the actual need. A few very stark facts may help answer that question.

In the past seven years, housing assistance for the poor has dropped from $30 billion a year to $7 billion (a 77% reduction). At the same time, the poverty level now encompasses 13.6% of our population. One million families are now on waiting lists for subsidized housing. As an individual developer, it is hard to even fathom a need of that magnitude. I am overwhelmed by our own situation, which is insignificant when viewed as part of the "big picture." My company currently maintains 779 low-income apartments. For those units, we have a waiting list of 1,063 families. With the rate of turnover we experience, people on this list will wait an average of 4.5 years to occupy one of our apartments. These are real families with real needs, facing more years of inadequate housing.

Across the country, another 12 million poverty-level families need housing assistance. Too many of these are totally homeless, and these homeless are not just individuals. The U.S. Conference of Mayors estimates 30-40% of the nation's homeless to be families.

Again, numbers of this magnitude are difficult to comprehend. Of a more personal, immediate nature, the affluent city of Virginia Beach, Virginia still has over 200 outhouses. The tourists don't see them, but they are there. In Northern Virginia, an average two bedroom apartment rents for $800/month. An income of $35,000 or more per year is required to afford such housing with any degree of comfort. This equates to an hourly wage of $16.83. What does the $8.00 an hour worker do for housing? Many of them sit on waiting lists.

In Tidewater, Virginia we watch as hundreds of low-income housing units are demolished for new development, with no affordable housing built to replace those lost. Finally, we see perhaps our greatest "hidden" shame - our rural housing conditions, where too many people live without bathrooms, insulation, or heat. These conditions are real; they exist now, and on a Sunday drive on our state's back roads clearly shows their extent.

So, the answer to whether or not need justifies cost depends on whether or not we believe families have the right to expect the opportunity to have a decent place to live. My own opinion and deeply held belief is that a compassionate nation must find a way to decently house its poor, and that the need more than justifies the cost to do so.

Credit an Effective Tool

Although only in existence for a relatively short period of time, it is clear that the tax credit is an effective tool in the development of low-income housing. From our own experience, we can state emphatically that the program works in our nation's rural areas.

To date, we have completed and rented four complexes utilizing the LIHC. These four projects contain a total of 151 housing units, all of which are occupied by low-income, tax-credit eligible families. All four developments are located within different Virginia localities (Accomack County, Isle of Wight County, James City County, and the City of Franklin).

The average incomes for families in these projects ranges from $10,830 for single individuals to $15,690 for four person families.

Each job is further assisted by a FmHA Section 515 loan and Interest Credit Agreement. None of the residents receives a deep subsidy, such as Section 8 or Rental Assistance. A demonstration of the effectiveness of the LIHC program is the fact that in other FmHA Section 515 complexes which we developed under the ACRS system, average incomes range from $12,500 to $16,500. This represents an income level up to 15% higher than that achieved under the tax credit program.

The basic reason for the early success of this program is that the tax credit is valuable to investors. Since developers build the projects which use the credits, this value to investors is passed through to the developer in the form of development fees. The following example of the economics of a tax credit project illustrates this value.

EXAMPLE

Assumptions:

1. FmHA Section 515 Rural Rental Housing Development of 40 units in County with median income of $22,500.
2. Total Development Cost: $1,440,000.
3. Land Acquisition Cost: $100,000.
4. Tax Credit Basis (#2 minus #3): $1,340,000 ($33,500/unit).

The annual tax credit amount for all 40 units (assuming eligible occupancy) is approximately $53,600 (4% of $1,340,000). This would provide $536,000 in tax credits over a 10-year period.

Since the developer cannot use more than $7,500 per year in tax credits (zero if his income is over $250,000/year), the credits will be marketed to investors through a syndicator. The syndicator assembles an Investor Limited Partnership, which pays a development fee (plus syndicator commission) in order to buy into the project. In return for this development fee, the investors receive 99% of the tax credits and a portion of cash flow and residual earnings.

The amount of fee paid to the developer is negotiable, but will range from 17% to 18% of the tax credit basis ($1,340,000 in this case). Based on this, the developer can expect to receive a fee of $228,000 - $239,500, payable to the developer either in four payments over one year or in four to five annual payments. The faster the developer receives his money, the less money he is likely to receive, due to the time value of money.

In this example we assume a payment schedule of four annual payments and a fee of $239,500. In return for this fee, the developer must deliver a complete project, rent all 40 units to eligible families, and guarantee that the project is well managed and remains tax-credit eligible for up to 15 years.

Accordingly, in our example, the developer will receive an annual $60,000 fee for four years. Of course, this fee does not go entirely to the developer if he has to make the internal subsidy described in the footnote to my prepared testimony.[1] In addition, the fee must compensate the developer for the out of pocket costs and year to two years of effort that it takes to put one of these projects together. In addition to the usual development hurdles of obtaining properly zoned land, assuring construction costs that make the project feasible and the other myriad details of developing a project, the developer, under the Section 515 program, must deal with an ever-increasing list of governmental requirements and increasingly arduous FmHA processing requirements. Of crucial importance, our developers fees must not only cover the cost of the projects that succeed, but also must cover our overhead cost on the many projects in which we invest a great deal of time and effort and for one reason or another do not go forward. Bottom line, the fee a developer receives on a tax credit project is most reasonable and well-earned.

On a FmHA Section 515 project, and with most other decent low-income housing, the low rents and limited investor return make the syndication of tax credits the only viable incentive for development. For example, return on a Section 515 development is limited to 8% of owners equity. In the sample project cited above, the project would require an equity investment of $43,200 (3% of total development cost). The developer can earn a maximum of $3,456 (8%) per year on this equity. For difficulties and risk involved in developing such a project, a bank Certificate of Deposit would be a more desirable place for the $43,200, and would earn the same 8%.

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[1] Turning to the project income side, the median income of $22,500 results in a maximum gross rent for a family of four of $338.00 per month, if the 40/60 test is used (60% of 22,500 divided by 12 months multiplied by the maximum rent contribution of 30%). Gross rent represents rent plus utilities. If the economic gross rent (rent required to pay operating expenses, and mortgage debt) for the unit to be occupied by this four person family is $350.00 per month, the developer must reimburse the tenant $12.00 per month. Assuming that 30 of the 40 units fall into this category, the developer would be subsidizing tenants $360.00 per month or $4,320.00 in the first year.

Inasmuch as the applicable median income is likely to rise faster than economic gross rents, the developer should be able to reduce the required subsidy on an annual basis. If the gap between allowable tenant rent and required project rent is reduced by $3.00 each year for four years, the total required subsidy will be $10,800. This is acceptable in return for a development fee of nearly $240,000.

Let me again emphasize that the 1% mortgage for fifty years available on a Section 515 project provides no direct financial benefit to the owner, other than to make the project affordable to low-income residents. All savings from mortgage reduction are passed through to tenants in the form of lower rents. If a tenant has a high enough income to pay more than the basic rent, such excess payments are called "overages" and are returned to FmHA as interest on the loan.

Suggested Improvements to the Credit Program

Although we are generally pleased with the tax credit program, some changes are necessary.

First, in many rural areas, developers are having serious trouble with the income limits of 50 or 60% of median, because many county medians are extremely low. Accordingly, we are pleased that in both the House and the Senate Finance Committee versions of the Technical Corrections Bill, owners would be allowed to base income either on county income or statewide income, whatever is higher. We urge speedy adoption of the Technical Corrections Bill containing this crucial change to housing rural America.

Second, there needs to be reconciliation between requirements of the tax credit provisions in the Internal Revenue Code and Farmers Home rules under Section 515. Often in Section 515 projects there is a deeper subsidy to the tenant, called "rental assistance." Under the authorizing statute for that program, a tenant must pay 30% of actual family income, and the subsidy covers the rest of the rent. However, under Section 42 of the Internal Revenue Code, the tenant rent is capped at 30% of either 50% or 60% of median, regardless of the family's income. Accordingly, if there is an increase in the family's income, the Farmers Home rule requires the tenant to pay a higher rent than authorized by Section 42 of the Internal Revenue Code. Again, the Technical Corrections Bill as passed by the House and reported by the Senate Finance Committee would cure this program inconsistency by permitting rents to increase to 30% of actual tenant income in situations such as these.

Third, Congress should consider a third income test for project qualification. In addition to the 20/50 and 40/60 standards, a 60/80 test should be allowed. Using this standard, at least 60% of the units would have to be occupied by families at 80% or less of median income, adjusted for family size. There is a good deal of statutory and regulatory precedent for using 80% of median as a low-income level, and its use would enhance the feasibility of the tax credit in states with low median incomes.

Fourth, to encourage provision of units to the lowest possible incomes, Congress should create a "sliding scale" of credit percentages based on the income limit used. For example, the 20/50 standard could be entitled to a 5% or 10% credit; the 40/60 could use the current 4% and 9%; and, the 60/80 test could utilize 3% and 8%.

Fifth, we believe that the $200,000 per year income cap on those who can receive full use of the credit should be eliminated. This would greatly broaden the market for the credit, especially among those individuals who, while not at the $200,000 level now, fear that they soon will be. As we recommend retention of the $7,000 limitation on use of the credit by a taxpayer, we do not think that elimination of the $200,000 income level will lead to the alleged tax shelter abuses that impelled the major reforms in the Tax Reform Act of 1986.

Mr. Chairman, we commend you for having this hearing, and especially the interest that you have shown in the housing problems of rural areas which we realize is not your particular constituency. Speaking now on behalf of the Council for Rural Housing and Development, we stand ready to work with you and your able staff in the efforts necessary to both extend and enhance the tax credit program.

Chairman **Rangel**. Let me thank the three of you. Whatever limited success we are having, it's because of the cooperation and the commitment of developers to assist us in refining the law, at least improving upon it. We have a lot more to do, and the worst possible atmosphere to do it in. What we are talking about today flies in the face of tax reform. The things that we are doing is what the administration and many Members of Congress, including myself—we would like to believe that everybody pays their fair share of taxes and not be able to find shelters. By the same token, when we don't have any other housing policy and there is no other way to provide it, then the problem is how much do you give in tax incentives and what do you get back for it, and whether the targeted constituency is going to receive shelter.

There's always an apprehension with Treasury that developers are asking for too much and are providing too little.

But I do think the understanding that we have limited resources to work with has brought a sincerity and a dedication and a partnership among the private sector to work with the Congress and to work with HUD and to work with cities and states that are able to provide other types of subsidies, to get a package that would provide for more housing. It's just unbelievable how the administration can say we have no housing shortage when so many people are just left out in the cold.

In any event, the bad news is that it's a rough atmosphere to legislate in. The good news is that there has to be an improvement next year. So I hope that while we are trying to perfect what we've got, that you might try to think of ways that are less costly, because the deficit is going to still be with us next year—and whether we are talking about tax incentives or whether we are talking about direct subsidies and grants, I hope that you allow the Congress, through this committee, to get the benefit of your thinking as to how we can do a better job if there is a change in the political atmosphere we have to work with.

I want to thank you. We will leave the record open in case there are some things you want to mention that you did not mention, and staff is aware of your recommendations and we are going to do the best that we can under the climate that we have to work in.

And I want to thank you for your contribution today, but, more importantly, over the last few months that we've had to work together.

Our last panel includes the Federal National Mortgage Association; Larry Dale is the senior vice president (multifamily activities). Andrew Ditton is the vice president of Local Initiatives Support Corp., Chicago, Ill. F. Barton Harvey III is deputy chairman of Enterprise Foundation of Columbia, Md., and Steve Ross from New York is the president of Related Companies.

And I would just like to say at the outset that we would not be where we are today if it was not for your input and your work, and we appreciate your support. I'm anxious to hear your testimony. Your entire statement will be placed into the record.

And, Mr. Ross, you may proceed.

STATEMENT OF STEPHEN M. ROSS, PRESIDENT, THE RELATED COMPANIES, INC., NEW YORK, NY

Mr. Ross. I'm the founder and chief executive of the Related Companies located in New York City, with offices in Miami and Boston.

For over 15 years Related has been active in raising equity for and developing low- and moderate-income housing. We have raised over $400 million in equity to finance in excess of 45,000 units of low- and moderate-income housing.

Through public partnerships we have purchased in excess of $350 million in tax-exempt housing bonds. As a developer, we have built over 100 low- and moderate-income projects, representing in excess of 12,000 units.

Finally, we are proud of our recent role as the first developer of affordable housing in New York City, built under the inclusionary zoning in section 421(a) tax certificate program. Some of these properties are located in your district, Mr. Chairman.

Of relevance today is the fact that we have sponsored liberty tax credit plus, an offering of equity interest in projects receiving the low-income housing credit. We initially sought to raise $40 million with the right to increase the offering to $80 million. At this time I am pleased to report that we have sold 13,000 shares to 7,000 investors, and have raised over $65 million. While that amount may seem large, it represents——

Chairman Rangel. Would you tell us how you did that?

Mr. Ross. We did that through a joint offering with Shearson Lehman Hutton, and we have raised that money in approximately 7 weeks.

While that does seem large, it only represents 4 percent of the $1.4 billion of potential 1988 tax credit investments.

Because we are so deeply involved in this tax credit program, we first want to commend you, Mr. Chairman, for holding these hearings.

Tax reform has often been justified as a weapon in the fight for social reform. Important business efforts can be stimulated by tax incentives. Tax policy as a factor in housing development is a consistent thread implementing social goals since World War II. There is now an opportunity to harness the business community to pursue similar social goals with dynamic and flexible tax policies. We believe that the tax credit program is basically a sound way to meet some of the low-income housing needs in this country, which in your very apt words have gone from bleak to frightening.

I don't believe that the tax credit program alone, though, is sufficient to meet our low-income housing needs. However, the tax credit program is a necessary adjunct to any new housing program. It is essential that it continue and be modified to make it work even better.

Although the tax credit program was slow to get started in 1987, it seems to be off the ground, as evidenced by the following.

First, there has been the beginning of an acceptance of the program by a new group of generally middle-income investors. Even with the current income cap on investors, we have managed to find market buyers for our tax credit offering.

Second, the development community has started to become involved with tax credit projects. However, we are finding very uneven results as we attempt to locate feasible projects around the country. In many areas, low-income housing projects simply do not work due to high construction costs and/or low median incomes.

I will address proposed solutions to these problems later in my testimony.

It seems a shame that this program is not working in some of the very areas which have the greatest need for low-income housing because of the cost-income relationships.

Considering the fact that the tax credit program represents an entirely new concept of utilizing the Internal Revenue Code to assist low-income housing, Congress took a remarkably good first step in structuring the credit. However, because of time constraints during the 1986 legislative consideration of the tax credit, it was impossible to foresee every problem so as to structure a perfect program. For that reason, let me suggest some very needed changes.

First, to broaden the market for the tax credit, I suggest that the income cap of $200,000 to $250,000 be modified. At the very least, a person who purchased a tax credit obligation when he or she was eligible, that is, earned under $200,000, should be grandfathered to be able to use the credit during its 10-year life, regardless whether the income increases over the $200,000 limit at any time during this 10-year period. This would not be as satisfactory a solution as removing the income cap altogether. If we are to encourage nearly 1.4 billion a year of private investment in low- and moderate-income housing through the tax credit program, it is necessary to broaden the eligible investor base. Removing this limit would not do violence to the principle guiding the 1986 act of eliminating shelters that allow wealthy individuals to escape all or most of their taxes, because the $7,000 use limitation by the taxpayer represents only a small fraction of a wealthy person's tax liability.

Second, we have a great problem in making the credit work in areas with high construction costs and low or average median incomes, such as New York City. It is ironic that the income limit of 50 or 60 percent of median income make it unworkable in areas of the greatest need, such as New York.

It is here relevant to note that the same income limits are applicable in the case of tax-exempt multifamily bonds. In that regard, I served as chairman on an advisory panel on affordable housing to Senator Alfonse D'Amato, and we recommended that in areas such as New York a new income formula be utilized relative to the multifamily bond program which would compare area construction costs and median incomes within a given area to the national standards so as to increase the median income levels to reflect increased local construction costs. That formula is set forth in my written testimony.

Third, under the present law the state agencies have the discretion to lower the credit percentage from the approximate 9 or 4 percent annual levels prescribed, but they do not allow the State agencies to have the discretion to raise these percentages if it is necessary to make a project feasible, particularly in areas with low income, which are therefore not able to generate the necessary rental to cover the debt service and operating expenses. The agencies should have this discretion, and it would cost the Government nothing.

Fourth, California and other States have adopted State low-income housing tax credit programs that parallels the Federal credit. Such State credit programs or similar State subsidy programs should be encouraged by the Federal Government. One way to do so would be to give extra credit allocations to those States which either adopt a State tax credit program or a State subsidy to achieve the same result.

Finally, as you are aware, the tax credit program sunsets on December 31, 1989. In other words, we are nearly one-half way into the 3-year life of the credit program. The sunset date, though, has some very disturbing implications to both developers and debt or equity financiers. Anyone planning a new construction or substantial rehab project now must seek 1989 credit allocation. It is virtually impossible to start now on a project that would be placed in service by December 31, 1988, and thus qualify for the 1988 credit. However, in about 6 to 8 months, or say in the fall of 1988, in many cases it will be too late to begin the planning of units to be placed in service by the end of 1989. Certainly by this time next year, no rational builder or developer would be expending any effort on a 1989 project; in other words, all credit activity will come to a halt under present law, as no one has any assurance there will be tax credits available for projects placed in service in 1990. Accordingly, what Congress thought was a 3-year program will really be a 2-year program at the very most.

Another important reason to act affirmatively now is to show that Congress really believes in the credit. In response to our selling efforts, we have met repeatedly with the question from individuals who have seen the 1986 Tax Reform Act impair their ability to take losses, whether Congress might take away the benefits of the credit before the 10-year period is over.

Although one Congress cannot bind a future Congress in this regard, a very good way to reassure these individuals of congressional support of the credit is to extend its sunset date.

For these reasons, I strongly suggest the Congress extend the program for at least one more year.

Mr. Chairman, my written testimony sets forth those suggestions with regard to technical corrections which I feel are important to be corrected as soon as possible.

Although my testimony is on technical tax, business, and legal issues, we cannot afford to forget that vital social needs motivate these tax programs. A free and productive society cannot maintain itself with millions of its citizens and their children either without adequate, decent housing, or actually homeless. The stability of America's future is at stake. Tax policies are fundamental tools to inspire the partnership of business and government.

Responsible developers, together with creative legislative leadership, can help break the cycle of poverty which contributes significantly to the deteriorating housing stock.

The moral fiber of this generation of business and government leaders will be tested by this challenge. It can be our legacy for a better world. Decent housing affords decent people an opportunity to have a stake in America's stability.

Thank you.

[The statement of Mr. Ross follows:]

TESTIMONY OF STEPHEN M. ROSS, PRESIDENT
THE RELATED COMPANIES

BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

March 2, 1988

My name is Stephen M. Ross. I am president and Chief Executive Officer of The Related Companies, Inc. of New York City.

By way of background, for over fifteen years Related has been extremely active in raising both equity for and developing low and moderate income projects. We have raised $400,000,000 in equity in both the private and public market for investment in low and moderate income housing, financing in excess of 45,000 units of housing. In addition, through a series of public partnerships, we have purchased in excess of $350,000,000 in tax exempt bonds to finance the development of some 40 projects. In another role, we have developed over 100 low and moderate income projects representing in excess of 12,000 units of subsidized housing. Additionally, we have developed six bond financed projects, including three in New York City. We are proud of our role as the first developer of affordable housing in New York City under the inclusionary zoning and Section 421(a) tax certificate programs.

Of relevance to the hearing today, one of our subsidiaries, Related Capital Corporation, is serving as a co-sponsor with Shearson Lehman Hutton of a publicly syndicated offering of equity interests in projects receiving the tax credit under Section 42 of the Internal Revenue Code. In the offering, we initially sought to raise $40,000,000 with a right to increase the offering to $80,000,000. At this time, I am pleased to report that we have sold 13,000 shares of the partnership (formally called Beneficial Assigned Certificates) to 7,000 investors for a total raise to date of $65,000,000, which, however, represents only 4% of the $1.4 billion of potential 1988 tax credit investment.

Because we are so deeply involved in the tax credit program, we first want to commend you, Mr. Chairman, for holding these hearings. Bottom line, we believe that the tax credit program is basically a sound way to meet some of the low income housing needs in this country which in your very apt words in the notice for this hearing have "gone from bleak to frightening." This is not to say that the tax credit program is sufficient to meet our low income housing needs, especially in the area of new housing production, but a new large scale production program is more properly addressed in housing legislation which I understand will be considered next year. However, as the tax credit program is a necessary adjunct to any new housing program, it is essential that it continue and be modified to make it work even better.

The Program is Now off the Ground

I am sure you are familiar with the fact that in 1987 only about one-fifth of the nation's credit allocation of $300 million was utilized. This can be explained in part by the time that it has taken the development community and concerned professionals to become familiar with this intricate and complex tax program. However, the program now seems to be off the ground as evidenced by the following:

First, there has been the beginning of an acceptance of the program by a new group of generally middle income investors. As you are aware, a taxpayer can only utilize the credit against about $7000 of his tax liability and only taxpayers with an adjusted gross income of less than $200,000 can fully utilize the credit with the benefit phasing out completely at the $250,000 income level. Even with these strictures, we have managed to find market buyers for our tax credit public offering which I have indicated represents only 4% of the potential 1988 investments; however the modifications discussed below are needed to obtain the necessary broad scale market required to place $1.4 billion of potential tax credit investment. In addition to our offering, I am aware of at least seven other public offerings and several private placements of tax credit investments, and generally there is a growing market acceptance of this investment.

Second, the development community is also starting to become involved with tax credit projects. However, we are finding very uneven results as we attempt to locate feasible projects around the country; in many areas, low-income housing projects simply do not work due to high construction costs and/or low median incomes. I will address proposed solutions to these problems later in my testimony. It seems a shame that this program is not working in some of the very areas which have the greatest need for low-income housing because of cost-income relationship.

Some Changes Are Needed To Make The Program Fully Effective

Considering the fact that the tax credit program represents an entirely new concept of utilizing the Internal Revenue Code to assist low income housing, Congress took a remarkably good first step in structuring the credit. However, because of time constraints during the 1986 legislative consideration of the tax credit legislation, it was impossible to foresee every problem so as to structure a perfect program. For that reason, let me suggest some very needed changes.

First, to broaden the market for the tax credit, I suggest that the income cap of $200,000 to $250,000 be modified. At the very least, a person who purchased a tax credit obligation when he or she was income-eligible, i.e. under $200,000, should be "grandfathered" to be able to use the credit during its ten-year life, regardless of whether their income raises over the $200,000 limit any time during the ten-year period.

This would not be as satisfactory a solution as removing the income cap altogether. If we are to encourage nearly $1.4 billion a year of private investment in low and moderate income housing through the tax credit program, it is necessary to broaden the eligible investor base.

Removing this limit would not do violence to the principal guiding the 1986 Act of eliminating shelters that allow wealthy individuals to escape all or most of their taxes. Because of the $7,000 use limitation by a taxpayer, only a small fraction of a wealthy person's tax liability would be eliminated through the low income housing tax credit.

Second, we have a great problem in making the credit work in areas with high construction costs and low or average median incomes, such as New York City. It is ironic that the income limit of 50% or 60% of median make it unworkable in areas of the greatest need, such as New York. It is here relevant to note that the same income limits are applicable in the case of tax-exempt multifamily bonds. In that regard, I served on an Advisory Panel on affordable housing to Senator Alfonse D'Amato, and we recommended that in areas such as New York, a new income formula be utilized relative to the multifamily bond program which would compare area construction costs and median incomes within a given area to the national standards. We developed a formula that is set forth in the appendix to my testimony. Our panel engaged Dodge Data Resources, Inc. to help establish a nationwide construction index, and we found that the cost of constructing multifamily housing in New York City is 1.54 times the average nationwide cost, while our median is just about the same as the national median. Accordingly, under the formula, the 50% of median income limitation would be increased by 54%, so that in New York City the equivalent qualifying income would be 77%. The same mechanism should be used for the tax credit as well as for multifamily bonds to make both of these necessary programs more workable.

Let me point out here that although we favor utilizing the higher of state or local medians, this change is not enough to help a high construction cost area such as New York City, thus justifying the above suggestion.

Third, under present law, the state credit agency has the discretion to lower the credit percentage from the approximate 9% or 4% annual levels prescribed in the Code if the agency believes that such percentages are not necessary to induce a developer to construct or rehabilitate the project. However, the state credit agencies have no discretion to raise these percentages if it is necessary to do so to make a project feasible, particularly in areas with low incomes which are therefore not able to generate necessary rental income to cover debt service and operating expenses. The agencies should have this discretion. Bear in mind that as the credit is capped, the state would have to trade off higher percentages for the projects that it funds with the downside that it will have fewer projects within the state. The overall revenue loss to the federal government would be the same due to the fact that the credit is capped. However, states will at least be able to assure feasible projects, especially in the case of existing projects where the 4% credit does not produce the funds needed to induce owners to sell. (Often the amount that the buyer can pay now is less than the current owner's tax liability on sale)

Fourth, California now has a state low income housing tax credit that parallels the federal credit. I understand that Governor Cuomo has proposed a similar credit for New York State, and that your former colleague, Lt. Gov. Stanley Lundine, has been charged with developing the program as well as other responsibilities in the area of housing. Such state credit programs, or similar state subsidy programs, should be encouraged by the federal government. One way to do so would be to give extra credit allocations to those states which either adopt a state tax credit program or a state subsidy to achieve the same result.

Fifth, a big problem with existing properties is that the HUD Section 8 commitment to a project expires during the compliance period. Possible solutions to this problem are a) make the Section 8 subsidy available during the entire compliance period, and b) increase the limited dividend distribution (allow an increase in equity or in the percentage of allowable return).

Although these remedies are beyond the jurisdiction of this Committee, we request that you make this concern known to HUD and the appropriate authorizing committees.

Sixth, under New York City's inclusionary zoning program, to obtain the necessary variances, the developer must agree to utilize the project for low income housing in perpetuity. In such case, there is concern that the projects may be deemed not entered into for profit and thus may be denied the necessary tax benefits by the IRS. Although we believe there is no merit to such a position under current law, it would be helpful if Congress pass legislation declarative of this interpretation of current law.

Seventh, the Congress has now before it technical corrections legislation with several changes affecting the tax credit program. As the House has adopted these changes as proposed in the original technical corrections bill last June, with some additional changes added by this Committee, I will not address them in detail. However, I do want to strongly encourage you to press for final enactment of a technical corrections bill to obtain such necessary changes as:

- liberalization of waiver of the ten-year rule on transfer of existing projects so as not to include transfers by a governmental agency or non-profit or when necessary to preserve low income use;
- carry-over of the credit if circumstances beyond the developer's control prevent it from being placed in service in the year of credit allocation;
- use of the higher of state or local median incomes;
- reconciling inconsistencies between requirements under the credit program and under subsidy programs as Section 8;
- making plain that both state as well as federal subsidies do not count against the 30% rent limit imposed on the tenant;
- allowing the developer to lock-in the credit percentage at time of reservation; and
- modifying the exception from the at risk rules from seller financing from a non-profit organization so it will apply where the financing is secured by interests in the partnership that owns the property. (Under current law it must be secured by the property).

Let me emphasize the need to enact these changes as soon as possible. We need them in 1988 - a crucial year for the credit program. If it appears that a technical corrections bill will not be enacted until late in the year, then we urge early separate enactment of the low income housing tax credit technical amendments.

Extend the Sunset Date

As you are aware, the tax credit program sunsets on December 31, 1989. In other words, we are nearly half-way into the three year life of the credit program. The sunset date has some very disturbing implications to those who are just starting to become involved with the tax credit program, either as developers or debt or equity financiers. Anyone planning a new construction or substantial rehabilitation project now must seek 1989 credit allocation, as it is virtually impossible to start now on a project that would be placed in service by December 31, 1988 and thus qualify for the 1988 credit. However, in about six to eight months, or say in the fall of 1988, in many cases it will be too late to begin the planning of units to be placed in service by the end of 1989. Certainly by this time next year, no rational builder or developer would be expending any effort on a 1989 project. In other words, all credit activity will come to a halt under present law as no one has any assurance that there will be tax credits available for projects placed in service in 1990. Accordingly, what Congress thought was a three-year program will really be a two-year program at the very most.

For that reason, I strongly suggest that Congress extend the program this year for at least one more year - until December 31, 1990. That will allow credit activity to continue in 1989. During 1989, Congress can take a closer look at the issue and hopefully will consider a longer extension of the program or making it permanent. What would be disastrous would be the extension of the credit in the waning days of the next Congress in December, 1989. An extension at that time would mean that there would be no planning and development of new projects in 1989, and no pipeline of projects that would be placed in service in 1990 to use the belatedly extended credit.

Another important reason to act affirmatively now is to show that Congress really believes in the credit. In response to our selling efforts, we have been met repeatedly with the question from individuals, who have seen the 1986 Tax Reform Act impair their ability to take losses, whether Congress might take away the benefits of the credit before the ten year period is over. Although one Congress cannot bind a future Congress in this regard, a very good way to reassure these individuals of congressional support for the credit is to extend its sunset date.

This Committee should rightfully be concerned with the revenue loss of this proposal. We as outsiders are not privy to the way the Joint Committee does determine such loss. However, we do know that in the Blue Book on the 1986 Act it was estimated that the cost of the low income housing tax credit would be $3.246 billion dollars over a five-year period. We also know that that figure will not be reached because of the very little utilization of the credit in 1987. Assuming a 20% utilization of the credit in 1987, or $60 million, and further assuming that 2/3 of the credit, or $200 million dollars, will be utilized in 1988 and 5/6 of the credit, or $250 million dollars, will be utilized in 1989, the total revenue loss on utilizing the credit over the five years beginning in 1987 would be $1.850 billion or far less than the estimated $3.2 billion. Accordingly, assuming that the program is extended to December 31, 1990, and assuming 100% utilization in 1990, or $300 million, the five-year loss in revenue would only be $2.450 billion, again less than originally estimated. Congress could extend the sunset this year until December 31, 1990 with no danger of exceeding the original five-year projection of estimated revenue loss.

Mr. Chairman, let me thank you again for holding these important hearings to focus on these crucial tax credit issues.

APPENDIX A

TAKEN FROM REPORT ON THE STATE OF NEW YORK'S TAX-EXEMPT BOND-FINANCED HOUSING PROGRAMS

Prepared by Senator Alfonse D'Amato's Advisory Panel on Affordable Housing
February, 1988

1. Multi-Family Program Changes

a. Income Limits

The Panel recommends that targeting for tax-exempt financed multi-family housing programs be adjusted by a formula which compares local costs of multi-family housing construction, land and area median incomes, with similar national costs and incomes. The current income limits (i.e., 50% or 60% of median) would be used as a base. In areas where the cost of construction exceeded the national average and/or where the median income fell below the nationwide median, the income limits could be adjusted upward. Areas where construction costs were lower than the national average or median income was higher would be held harmless from a reduction in the new income limits imposed by the Tax Act.

The formula which the Panel recommends be adopted would compare area construction costs and median incomes to such national standards. The numerator of the formula would compare area costs of multi-family housing construction with nationwide costs. The denominator would compare area median incomes with the national median income. The formula is expressed below:

$$\frac{\text{area cost of multi-family construction}}{\text{national cost of multi-family construction}} \div \frac{\text{area median income}}{\text{national median income}}$$

The Panel recognizes that construction costs and median incomes are not necessarily the only factors which should be utilized in adjusting the income limits imposed on state and local governments by the Tax Act. Such factors as land costs and operating expenses should, ideally, also be considered. However, the adoption of an index based on all these factors might be too problematical to produce. Therefore, the Panel believes that a construction cost/median income index would be the most practical to devise and adopt and that it would help to alleviate many of the problems created by the inflexible income limits imposed by the Tax Act. In high cost/low median income areas, it is simply not feasible for tenants at 50% of median income or below to pay sufficient rent to enable project owners to meet their expenses, including debt service. This is particularly true in high cost areas with low median incomes. Contrast New York City, where 50% of median income is $14,750 and it may cost in excess of $100,000 to construct a unit, with suburban Washington, where 50% of median income exceeds $20,000 and the cost of constructing a garden apartment may be only half as much as in New York City.

The concept of a construction cost index that recognizes variations in local construction costs has already been proposed for hospital capital costs. The Department of Health and Human Services (HHS) engaged Dodge Data Resources, Inc. to develop the construction cost index.

The database was developed by Dodge under which a national construction cost mean was set as 1.000. Local variations were taken into account by accumulating a fifteen year average cost comparison of 365 different geographic areas, and dividing that number by national costs for the same period. That construction index ranges from a low of .728 to a high of 1.717.

This Panel also engaged Dodge to prepare a cost index for multi-family housing, comparing New York City to the nationwide average. The Dodge index indicates that the cost of constructing multi-family housing in New York City is 1.54 times the average nationwide cost. Thus, 1.54 would be the numerator in the proposed formula. As the New York City median is the same as the national median income, the denominator of the proposed formula would be 1.00. Using this formula, the 50% of median income standard would be eligible to be increased to 77% of median (50% x 1.54 ÷ 1). The Panel would imagine that New York City's ratio would be among the highest in the nation. Therefore, it is likely that most other high cost low median income localities will fall between 50% and 77% of median income.

Chairman **Rangel**. Thank you, Mr. Ross. Mr. Harvey.

STATEMENT OF F. BARTON HARVEY III, DEPUTY CHAIRMAN, ENTERPRISE FOUNDATION, COLUMBIA, MD

Mr. **Harvey**. Thank you, Mr. Chairman. My name is Bart Harvey, and I am deputy chairman of the Enterprise Foundation. James W. Rouse, our chairman, appeared before you and members of the Ways and Means Committee on July 9, 1985, to discuss provisions that eventually became the low-income housing tax credit, and we are delighted to be appearing before you again.

My written statement is submitted into the record, and I would just like to make some comments.

A subsidiary of the Enterprise Foundation worked extensively with these tax credits in 1987. It raised $7.6 million in 8 transactions in 6 cities for 585 units of low-income units, and it has commitments of over $50 million from 22 corporations for in excess of 20 different transactions for 1988 and 1989. We work with nonprofits primarily, and we sell the tax credits to corporate investors. We are working in New York and in fact in your district, and we are working on a major program with Fannie Mae, and Mr. Dale.

First of all, I'd like to commend Mr. Davie and others for the targeting of the low-income housing tax credit as well as for the provisions that allow the benefits to truly go to the poor. Those parts of the tax credit we feel are very important to be preserved in any changes that may need to be made.

A brief look at the history shows that this tax credit originally was going to be part of the code and directly accessible as other parts of the code are. However, in the 11th hour, it was allocated on a per-capita basis to the States and then capped. Therefore, many of the provisions and complexities are duplicative and unnecessary in light that it is capped and allocated.

I'd like to comment on some structural, marketing, and preservation issues.

As far as the structure of the tax credit goes, it's very apparent I think from the prior testimony and from our own experience that this tax credit cannot stand alone, and that in all cases that we are using it, we are using it with other additional subsidies from States and localities.

Chairman **Rangel**. Mr. Harvey, that point is made by everybody, but I would have expected that you, more than anyone else, would have known the atmosphere in which we had to get that credit out—and there is no question that it cannot stand alone.

Mr. **Harvey**. Right, I understand that. And I think that nonprofits and others have therefore had to go out and find ways of using it.

We therefore don't think there is any abuse from it being combined with other Federal, State, or local programs, and therefore that is one of our suggestions. For new construction or substantial rehabilitation, particularly in high-cost areas, that it be allowed to be combined without penalty with tax-exempt financing or other Federal assistance. That is one of the major changes that we would recommend and that would allow the credit to finally produce housing that could help eliminate the problems of homelessness and housing for the very poor in the cities. That's the so-called double dip that was again put in at the 11th hour.

As far as marketing goes—and this is for the corporate market—to make it most effective and efficient, there are some changes that could be made. For instance, the tax credit could be transferrable to the investor. We have found in going to corporations, it's a very hard sell—I think Mr. Clancy and others have said that. And the corporations are not interested in owning low-income housing per se. If you make the tax credit transferrable, you will be able to develop a very efficient market, corporations will be able to buy and sell the tax credit on a very efficient means. If you think of the project as the corpus of a bond and the tax credits as the coupons, as long as the project is successful, the corporations will get their tax credits—or coupons. Therefore the project still has to be successful. And it's one of the means that you could look at making the corporate market large enough and efficient enough, with little transaction cost, to make this a more effective provision.

That also leads to the issue of preservation. We are very concerned that we not face in 15 years the issues that we are facing now and that you are facing in your proposed bill, H.R. 3663. Therefore we would recommend that developers be able, particularly nonprofit developers, be able to enter into upfront donations. The Tax Code does not permit that right now. Developers could make sure that the property could remain low-income in perpetuity, if they wished to, on a voluntary basis. And we have made some suggestions in the written testimony for that. Also if it was a transferrable tax credit, prevention would be allowed to happen from the outset as well.

Finally, we recommend, under a fairness doctrine, looking at what homeowners are receiving in the way of tax benefits, that this tax credit become a permanent part of tax law. There's over $40 billion that are going to homeowners, and particularly wealthy homeowners; the poor are renters, by and large, and there's very little for them in the Tax Code. So we heartily recommend that the sunset be removed and that this be made permanent.

To summarize, the technical corrections need to be passed as soon as possible. We recommend removing the sunset, removing penalties from using the tax credit with tax-exempt or other federally assisted funds, particularly for new construction or substantial rehabilitation. We would like to see other preservation issues, particularly donation up front.

Thank you very much.

[The statement of Mr. Harvey follows:]

STATEMENT
ON BEHALF OF
THE ENTERPRISE FOUNDATION
REGARDING
LOW INCOME HOUSING TAX CREDITS
BEFORE
THE SUBCOMMITTEE ON
SELECT REVENUE MEASURES
OF THE HOUSE
COMMITTEE ON WAYS AND MEANS

BY
F. BARTON HARVEY
MARCH 2, 1988

Mr. Chairman, Members of the Subcommittee. My name is Bart Harvey and I am Deputy Chairman of The Enterprise Foundation. Thank you for the opportunity to testify before this subcommittee on the use, effectiveness, recommended changes for and future use of the Low-Income Housing Tax Credits.

James W. Rouse, Chairman of The Enterprise Foundation, testified on July 9, 1985 before The Ways and Means Committee regarding the impact of the Administration's tax reform proposals on non-profit private sector initiatives for housing the very poor. His testimony concerned itself with tax incentives for rental housing for very poor people. The Enterprise Foundation was extensively consulted by Congressional staff regarding provisions involving what became the Low-Income Housing Tax Credit.

I. The Enterprise Foundation

The Enterprise Foundation is a national, publicly supported, 501(c)(3) charitable organization launched by James Rouse in 1982 and devoted to helping poor people help themselves to decent, affordable housing and out of poverty into self-sufficiency. The Enterprise Foundation has a distinguished and active Board of Trustees drawn from business, government and housing experts (Appendix I). The Foundation has raised over $40 million from individuals, corporations, and foundations to support its work with 70 non-profit groups in 27 cities and The State of Maine.

Enterprise provides technical assistance and "seed" grant money to help non-profit groups achieve their objectives. It has helped produce over 3,000 units of housing for very poor people costing over $100 million and to employ over 5,000 "hard-to-employ" people through its 17 job placement centers.

As importantly, it is working at the systems of housing for poor people in this country. Its Rehab Work Group finds ways to cut the cost of new construction and housing rehabilitation and its wholly-owned subsidiary, The Enterprise Social Investment Corporation, finds ways to finance low-income housing including the use of low-income housing tax credits.

In all its effort, The Enterprise Foundation is forging partnerships between business and the public sector, examining new ways to harness the creativity and disciplines of the free enterprise systems to encourage the initiative and efforts of non-profit neighborhood groups. Enterprise is adapting self-help programs that work for use with its network of neighborhood groups and finding ways for corporations and other private sector groups to participate in housing poor people in a responsible, meaningful way.

II. Use of the Low-Income Housing Tax Credit

The Enterprise Social Investment Corporation ("ESIC") has been an active participant in the use of The Low-Income Housing Tax Credit ("tax credit") with non-profits across the country. Since non-profit groups can not use the tax credits, they must form a partnership with a for-profit limited partner who can use the tax credit through this partnership arrangement. ESIC makes sure all the money raised through the use of tax credits are put back into the project or other low-income housing. It has raised over $7.6 million through limited partnerships in eight non-profit projects involving 585 units of low-income housing, most of which were substantial rehabilitations and all of which involved corporate limited partnerships. All these projects had a substantial amount of other subsidy monies.

ESIC has commitments from two large corporate investors for up to $48 million of investment in tax credit projects under certain prescribed conditions, and it has twenty-two other corporations which have made modest commitments for such investments. ESIC is currently structuring limited partnerships in 14 projects in the cities of Baltimore, Cincinnati, Cleveland, Los Angeles, Miami, Philadelphia, Raleigh, N.C., and Washington, D.C. costing over $50 million, involving over 800 units of low-income housing.

In New York City, ESIC has a committed investor for $28 million of equity investment in over 1,000 units costing about $90 million. ESIC believes it is one of the major participants in creating partnerships that are using tax credits for non-profit urban area projects.

III. Observations Regarding the Use of the Tax Credit

From our own experience and checking with other organizations involved in the selling of tax credits , a number of points are important. In 1987, very little use of the tax credits (perhaps 25% nationally) resulted due to structural, marketing, and regulatory problems involved in the use of the credit.

(1) Structural Issues: In almost every locality in the country, the tax credit, on a stand alone basis, will not result in the production or substantial rehabilitation of low-income housing. It usually requires substantial additional subsidies.

Furthermore, the requirement that rents, inclusive of utility costs, be fixed at 30% of median income implies in a historical context that project costs will rise faster than rents, leading to potential operating losses in later years. Additionally, financial institution underwriters look at the possibility of median incomes actually decreasing in certain areas, which would mnean lower rents even if operating costs increased.

From a financing point of view, developers and lenders must be certain that tax credits are available as equity raised is based upon receipt of certain amounts of credit. The equity raised is usually an integral part of the financing package. However, the amount of the credits receivable varies month to month based upon a formula and more importantly, if a project is held up for whatever reason, the credits may not be receivable at all.

It is also clear that the credit coupled with tax-exempt financing cannot produce low-income housing on a stand alone basis. Furthermore, the sheer complexity of mixed use projects and the complicated regulations deter non-profit and for-profit developers from attempting this type of financing.

The determination of federal and non-federal money on the credit percentage receivable and a host of related financing issues add complexity to an already complex arrangement.

Finally, in an era where Congress is dealing with the preservation of existing, government assisted, housing stock left unprotected by the owner's contractual right to prepay and convert to higher income tenants, the tax credit regulations set up this very same issue after 15 years. The value of potential appreciation of low-income housing stock is not included in the pricing of most tax credit deals. Most limited partners only want the likelihood to dispose of the housing at the end of 15 years without loss. Why should Congress face similar conversion issues in 15 years where the investors might receive an unexpected windfall and the government lose important low-income housing stock? It should provide incentives to maintain the low-income character of the housing after 15 years without loss to the investor.

(2) Marketing Issues: The extension of the passive loss rules to tax credits eliminated the natural market for these investments, limited the size of the eligible investment, and greatly complicated the marketability of tax credits. Two markets are open to sale of the credits, publicly traded partnerships consisting of small investors, and corporations. As marketing tax credits to small investors through publicly traded partnerships is expensive, time consuming, and inefficient and raises issues as to the applicability of the investment for those individuals, ESIC concentrated on corporations.

Most corporate investors have never owned low-income housing, are unused to receiving tax credits over 10 years, are uncomfortable holding real estate unrelated to their principal business, are adverse to the legal complexities surrounding this investment and are uneasy about the recapture provisions in this tax credit.

ESIC approached major corporations on the basis of a market rate of return, security of the structuring of the investment, removing real estate from the decision, and establishing good corporate community responsibility. Our two major corporate investors understand real estate extremely well and their C.E.O.'s are genuinely interested in providing low-income housing. Other corporations have invested partially out of good citizenship and in smaller amounts.

In successful cases, corporate C.E.O.'s were directly contacted by Board Members and extensive follow up visits were required with legal, accounting, tax, finance, public relations and corporate contribution personnel. The process has been extensively time consuming.

Security of investment remains the prime concern, and certain structural obstacles needed to be surmounted. A 15-20% rate of return on invested capital was offered and tight restrictions were put on any resale value at the end of 15 years. Both projected credits and tax-effected partnership deductions were available with total projected after tax benefits over 15 years being slightly less than one and three-quarters times the investment. Corporations, as limited partners, accepted the risks that their tax benefits were subject to recapture or reduction. They also had to take into account the retroactive treatment accorded low-income housing losses by the Tax Reform Act of 1986. Most attached some benefit to the corporate responsibility of the action, particularly, an investment in their headquarters community.

It is clear with the risk factors involved, the unusual nature of the investments, the small project sizes, and the difficult legal and real estate issues, that corporations will not be major buyers of tax credit projects. Certainly not in the size of the $3 billion dollars worth of investment needed to use the available tax credits for 1988 and 1989.

(3) Regulatory Issues: Due to the extreme complexity of the regulations for the tax credits, the lack of promulgated Treasury regulations and the need for significant technical corrections, and clarification of issues, a number of developers and investors are unwilling to participate in tax-credit projects. Furthermore, the thicket of complex provisions has lead to considerable inefficiences due to legal, accounting and marketing costs.

IV. Improvements

Background: In noting needed improvements, it is informative to track the evolution of the tax credits. The complexity of their structure and some particularly important provisions were added to limit revenue loss to the U.S. Government since the credits were originally proposed to be directly acessible by qualifying projects. Therefore, restrictions as to type of permitted structures, type of financing funds used, and limitations on qualifying basis all had revenue implications.

However, at the eleventh hour, these tax credits were allocated to states on a per capita basis, and capped. A host of provisions were rendered duplicative, and futhermore limited the effectiveness of states and localities to use these credits to respond to their own situations. Future tax credit policy should recognize this fact, and look toward simplification and discretion at the local level.

Additionally, future tax credit policy should fit local housing policy rather than dictate it. In the growing national movement toward local housing solutions, tax credit allocation and policy, particularly as it is administered through State Housing Credit agencies, should be as flexible as possible. The concept of the credit, to serve very low income people, and benefit directly those being assisted, is highly commendable. The elimination of past excesses in low-income housing tax policy - non-targeted use of federal benefits, the use of tax-exempt financing to earn arbitrage profits or develop market rate housing, excessive front-loading of tax benefits - all should continue to be prohibited. Yet the tax credits must be made more permanent, efficient, flexible and usable.

The Enterprise Foundation would recommend the following improvements:

(1) Quick Passage of Tax Credit Technical Corrections already Approved by The Joint Tax Committee.

Certain technical correction provisions are essential to keep projects moving forward in 1988 and to clarify ambiguous issues.

(2) Eliminate the Sunset Date for Tax Credits, Extending the Program Indefinitely.

Providing adequate housing supply for the poor is a long term job, requiring production mechanisms to be available for the foreseeable future. State agencies that administer the tax credit program must devote considerable time and resources to build their capacity. Similarly, private developers and non-profit groups must learn how the program works and how to use it effectively. None of these participants should be expected to make a substantial investment in building capacity for a program that will terminate in less than two years. (See Section V).

(3) Remove Penalties on the Use of Tax Credit With Tax-Exempt Financing and Other Federal Assistance Programs for New Construction or Substantial Rehabilitation Projects.

Federal housing programs have consistently depended on a combination of direct subsidies and tax incentives. The tax credit statute ignores this history by attempting to prevent the use of tax credit with direct housing assistance. Both analysis and experience demonstrate that the low-income credit alone is not sufficient to provide an incentive for the production of housing. State and local governments should be permitted to and should expect to use the tax credit together with whatever other forms of assistance is necessary. In certain cases, such as The Farmer Home Loan Program, State Credit Agencies have the ability to reduce the amount of credit allocatible if it is not all necessary for financing such projects. Alternatively, State Credit Agencies might limit the amount of equity proceeds raised from tax credits that might be withdrawn from a project.

(4) Remove the Tax Credit from the Passive Loss Rule. Apply Strengthened Business Credit Limitations to Individuals. Alternatively, Make the Tax Credit Refundable or Transferable.

The application of the passive loss rule to low-income tax credits substantially undermines their value. This rule denies low-income housing its traditional investment market, the so-called "accredited investors" under the securities laws. Instead, owners of tax credit projects are forced to find investors through costly public syndications or in a corporate market that is unfamiliar with and highly suspicious of low-income housing. As a result, much of the benefit of the low-income tax credit is lost in transactional and other costs. If Congress wishes to limit the amount of credit available to any individual, it can do so directly through a more restrictive business credit limitation, or a minimum annual credit amount that can be taken by individuals. By far the most efficient use of the tax credit would be to make it refundable to the Treasury, permitting long term ownership by non-profit developers or to make it transferable to the investor.

(5) Allow Flexibility in Rent Levels to Reflect Substantial Operating Cost Increases.

Rents pegged to median income will not necessarily relect substantial increases in utility and operating costs. Furthermore, median income may decline while operating cost increases, decreasing rents. In order to finance tax credit projects, initial rent levels should not decline if median income declines, and some capped level of rent increases should be permitted based upon an area index of increased operating costs which are not reflected in median income increases.

(6) Remove Penalty in Qualified Basis for Non-Profit Below Market Rate Lending.

Below market rate loans provided by non-profit lenders to tax credit projects must be discounted to a market rate and adjusted for tax credit basis while below market rate loans by state or local government, or financial institution lenders are not so discounted. This inequality as to source of funds should be removed.

(7) Permit the Carryover of Tax Credit Authority and its Reallocation Among States.

Current law requires projects to be placed in service in the year the tax credit was allocated. The development of multifamily housing is highly vulnerable to construction delays; low-income housing, in particular, is difficult to develop and finance. The rule against carryover creates unacceptable risks for investors and lenders, since a construction delay can result in the loss of all tax credits.

Tax credits allocated to a specific project should be able to be carried over so long as the project commences construction in the following year. Credits not allocated to projects in the year of initial allotment and credit authority allocated to projects not beginning construction by the following year would be reallocated to other states as an addition to those states' per capita limits.

(8) Allow Greater Flexibility in Allocating Tax Credits and Donating Interests.

Owners should be allowed to allocate tax credits to investors in accordance with their capital contributions to a project.

Further, the Internal Revenue Code should permit investors in tax-credit projects to enter contractual agreements at the time of financing to donate their interests to non-profit organizations or governmental agencies at the end of the holding period, without receiving tax benefits or incurring any tax liability at the time of such donation. Such a policy would maintain low-income housing for longer periods than 15 years.

(9) Clarify That Eligible Units Available to General Public include Units Designed for Special Needs Groups.

For a unit to be available to the general public, it can not be restricted to members of a particular organization. However, this should not forbid the eligibility of units, which are not used as transient housing, designed for special need groups, such as the homeless, handicapped or elderly.

(10) Consider Special Regulations for Use of Tax Credits to Preserve Existing Government Assisted Housing.

A major national problem is the retention of the existing inventory of privately owned, assisted rental housing for low-income people. Due to expiring Federal and private commitments, a large portion of this housing could be converted to higher income or other use. Certain provisions of the tax credit, specifically the 10 year last placed in service rule, need to be modified for their effective use in preserving this stock.

V. Need for Tax Credits as Part of National Housing Policy

Federal tax policy is a critical element in national housing policy. It affects the choices of families to rent or to buy. It has a substantial impact on the proportion of real, after-tax income which people spend for housing. Sound tax policy complements other government policies affecting housing.

Reflecting the great priority Americans give homeownership, the tax code allows the deduction of mortgage interest and property taxes, tax-free rollover of appreciated property and tax exemption on gains for homeowners over 55. This favorable treatment, amounting to over $40 billion per year at present, has played a major role in enabling the United States to become a nation of homeowners, and it contributes significantly to the accrued savings which Americans have in their homes.

Tax policy towards rental housing has been substantially less supportive and less consistent. With tax incentives virtually eliminated by the 1986 Tax Reform Act, rental production has dropped sharply.

Rental housing is overwhelmingly the housing of the poor. Renter median incomes are half those of owners; more than 60% of the nation's poverty households are renters. Current tax policies which disfavor rental housing hit the poor particularly hard. They force lower income families to compete with more affluent renters for a declining supply of affordable units. *They discourage the production of new units at rents* which are affordable to the working poor without additional subsidy, or to the very poor who receive government support. They increase rent burdens for a population already paying a disproportionate share of its income for housing costs.

Tax-exempt financing and the low-income tax credit have been critical elements in the recent growth of state and local low-income housing efforts. The need for investors brings private sector integrity to housing production and rehabilitation, and the severe penalties to an investor inherent in a failed tax credit project, encourages only projects that are likely to be run successfully to go forward.

The challenge for the Congress is to chart tax policy which respects reform, resists abuse, prevents waste, and meshes with sensible housing policy. The tax credits are a very targeted resource, which if they can be flexibly incorporated with other sources of housing financing can produce the essential need of decent, affordable housing for America's poor. Thank you.

APPENDIX I

TRUSTEES

Lisle C. Carter, Jr., Esquire
Partner, Verner, Liipfert, Bernhard, McPherson & Hand, Chartered.

N. Gordon Cosby
Minister, The Church of the Saviour, Washington, D.C.; Co-Founder and Chairman of the Board, Jubilee Housing, Inc.

Mathias J. DeVito
Chairman of the Board and Chief Executive Officer, The Rouse Company.

Cushing N. Dolbeare
Consultant on Housing and Public Policy.

Coy Eklund
Former Chairman of the Board and Chief Executive Officer, The Equitable Life Assurance Society of the United States.

The Honorable John W. Gardner
Writer, Consultant.

Samuel Gary
Chairman of the Board, Gary-Williams Oil Producer, Gary Energy Corporation and The Piton Foundation.

W. H. Krome George
Former Chairman and Chief Executive Officer, Aluminum Company of America.

Ronald Grzywinski
Chairman of the Executive Committee, South Shore Bank of Chicago.

Ernest W. Hahn
Chairman of the Board, The Hahn Company.

F. Barton Harvey, III
Deputy Chairman, The Enterprise Foundation.

Andrew Heiskell
Fellow, Harvard College; Chairman of the President's Committee on the Arts and the Humanities; Chairman of the Board, The New York Public Library and The Bryant Park Restoration Corporation; Honorary Trustee, The Brookings Institution.

Jing Lyman
Founder/President, HUB Co-ventures for Women's Enterprise; Board Member, The Mary MacLeod Bethune Memorial Museum and National Archives for Black Women's History; Trustee, Working Assets Money Fund.

David O. Maxwell
Chairman and Chief Executive Officer, Fannie Mae.

The Honorable Robert S. McNamara
Former President, The World Bank.

Louis E. Martin
Assistant Vice President for Communications, Department of University Relations, Howard University.

Leeda Marting
Consultant.

The Honorable Charles McC. Mathias, Jr.
Former U.S. Senator from Maryland; Partner, Jones, Day, Reavis and Pogue.

Milton J. Petrie
Chairman of the Board, Petrie Stores Corporation.

Edward L. Quinn
President, The Enterprise Foundation.

The Honorable Charles S. Robb
Former Governor, The Commonwealth of Virginia; Partner, Hunton & Williams.

The Honorable Henry S. Reuss
Former U.S. Congressman and Chairman, House Committee on Banking, Finance and Urban Affairs, and Joint Economic Committee.

James W. Rouse
Chairman, The Enterprise Foundation and The Enterprise Development Company.

Patricia T. Rouse
Secretary-Treasurer, The Enterprise Foundation; Board Member, World Times, Inc. and Mediators Productions, Inc

Andrew C. Sigler
Chairman and Chief Executive Officer, Champion International Corporation.

Ellen Sulzberger Straus
Chair of the Executive Committee, New York City Partnership.

Alexander B. Trowbridge
President, National Association of Manufacturers.

The Honorable Andrew J. Young
Mayor, The City of Atlanta; Former U.S. Ambassador to the United Nations; Former U.S. Congressman from Georgia.

Raul Yzaguirre
President and Chief Executive Officer, National Council of La Raza.

Barry Zigas
President, National Low Income Housing Coalition.

Chairman RANGEL. Thank you, Mr. Harvey. Mr. Ditton.

STATEMENT OF ANDREW DITTON, VICE PRESIDENT, LOCAL INITIATIVES SUPPORT CORP., CHICAGO, ILL.

Mr. DITTON. Thank you, Mr. Chairman. The organization I work for, Local Initiatives Support Corp., or LISC, is a national nonprofit organization that assists nonprofit community-based corporations to develop low-income housing and otherwise revitalize economically distressed neighborhoods. Since it started in 1980, LISC has made over 1,000 grants, loans, and investments in projects sponsored by nearly 500 CDC's. We now operate 30 local, regional, or statewide programs from coast to coast.

In this effort we have raised about $150 million from corporations and foundations. The projects we have assisted have produced or are producing over 14,000 units of affordable lower income housing, and 4 million square feet of commercial space, all in low-income neighborhoods. Virtually all of this activity has taken place since the Federal Government began its sharp curtailment of funding for low-income housing and community development.

LISC enthusiastically supported the enactment of the low-income housing tax credit, and we have worked hard to make it a useful tool for rehabilitating and building low-income housing.

To attract investment based on the credit, LISC has created a series of investment pools designed to appeal to large corporations. In 1987 we raised $14¼ million in investments from 13 corporations; these funds have attracted an additional $45 million in private and public financing for 24 projects containing over 1,000 units of affordable housing.

In 1988 we expect to raise an additional $50 million from corporations which will attract an estimated $90 million from other sources to produce 2,000 units of affordable housing.

In our experience corporations participate in our investment pools for several reasons. First and foremost, they expect to receive a competitive rate of return. We have generally not found corporations willing to accept a below-market return. The primary source of this return is the low-income housing tax credit. Cash flows from low-income housing projects are negligible and prospects for capital appreciation in most low-income neighborhoods are speculative at best. The credit is absolutely essential to making these investments, and therefore these projects, possible.

Second, LISC's successful and extensive track record with similar CDC projects has been important in assuring corporations that their investments will be prudently managed. Most of these corporations have had little experience with CDC's or low-income housing in distressed neighborhoods, and they have no interest in day-to-day involvement in these activities.

Third, these companies recognize that inadequate low-income housing and neighborhood deterioration are important problems nationwide and in the communities where they operate. While social concerns alone are not sufficient reason for them to invest in low-income housing, corporate leaders with a heightened sense of civic responsibility have been the most receptive to considering low-income housing as an investment.

LISC is channeling the investment funds raised from corporations to projects sponsored by nonprofit housing development organizations. The typical project involves the acquisition and rehabilitation of one or more apartment buildings in low-income neighborhoods. On average, 80 percent of the units in our projects are low-income-occupied. These projects are selected to fit into an ongoing neighborhood revitalization program rather than as isolated one-shot developments. Thus each successive project not only provides a much-needed source of low-income housing, but also bolsters other low-income housing in the neighborhood and sets the stage for subsequent development.

For example, in New York City, LISC is working with 10 CDC's and the city government on an unprecedented demonstration program to rehabilitate about 1,000 units of housing the city has taken over for failure of their owners to pay taxes. All of these buildings are vacant, abandoned, and have been serious blighting influences on the already distressed neighborhoods where they are located. The city is turning these buildings over to the CDC's and is providing substantial construction and permanent mortgage financing at interest rates low enough to permit affordability by low-income tenants.

LISC is providing $25,000 to $30,000 per unit, or about one-third of the total development cost, in equity investment raised from corporations through its New York equity fund. LISC has also provided planning grants, technical assistance, and working capital to the CDC's. And these projects are scheduled for occupancy in late 1989.

Our experience suggests that the credit, while far from perfect, is a fundamentally useful tool under certain circumstances. However, we would offer several recommendations for improving both its effectiveness and its cost efficiency.

Our first recommendation—and you've heard this before—is that Congress should act this year to extend the credits to projects placed in service through 1992. Low-income housing projects take a long time to complete; it is common for 2 or 3 years to elapse from the time planning starts to the time housing is ready for occupancy. As such, that projects must be completed by the end of next year to qualify for a credit is fast becoming a serious problem. Developers and investors are only now beginning to understand how the credit works. Because the credit is new and complicated, many prospective participants are not willing to spend the time learning about the credit, if it will be available for so short a period.

If the credit is to become a fully effective tool, there must be time to develop a steady pipeline of projects, and developers must be confident that the credit will be available when projects are completed. States and localities, nonprofit and for-profit developers, business corporations, private lenders, and foundations are all ready to join with the Federal Government to provide low-income housing. But the Federal Government must be a faithful and reliable partner. Turning the credits on and off is no way to run a housing policy.

Second, we recommend that Congress remove the penalties currently imposed on projects that combine the credit with tax-exempt financing, or Federal grants and below-market-rate loans. Virtually every credit project requires some other form of public subsidy to make it work, as you've already pointed out. The credit is simply not large enough to make projects economically feasible by itself, given what we believe are appropriately rigorous low-income targeting standards. The reason is simple mathematics: rents must be low enough both to be affordable and to meet the rules of the credit. Once operating costs are paid, only a small mortgage can be carried at prevailing market interest rates. Some additional subsidy is needed to fill the financing gap, and the limited availability of other public subsidies is perhaps the most important obstacle LISC has faced in making projects workable with the credit.

Third, we recommend that Congress relax the passive activity loss and credit restrictions on individuals investing in projects that receive the credit. I believe other witnesses have already explained why this is necessary.

Finally, we urge Congress to pass a technical corrections bill that incorporates provisions affecting the low-income housing tax credit that were already approved by the House Ways and Means Committee and the Senate Finance Committee last year. While we have succeeded in using the credit, the law as enacted in 1986 is far from perfect. Numerous changes of a primarily technical nature are needed to make the credit more effective and easy to use.

Thank you, Mr. Chairman.

[The statement of Mr. Ditton follows:]

TESTIMONY OF ANDREW DITTON

Thank you, Mr. Chairman. I am Andrew Ditton, Vice-President of the Local Initiatives Support Corporation, or "LISC". LISC is a national nonprofit organization that assists nonprofit community-based development corporations, or "CDCs", to develop low-income housing and otherwise revitalize economically distressed neighborhoods. Since it started in 1980, LISC has made over 1,000 grants, loans, and investments in projects sponsored by 482 CDCs. We now operate 30 local, regional or statewide programs from coast to coast. In this effort, we have raised about $150 million from corporations and foundations. The projects we have assisted have produced or are producing 14,000 units of affordable, lower-income housing and four million square feet of commercial space, all in low-income neighborhoods. Virtually all of this activity has taken place since the federal government started its sharp curtailment of funding for low-income housing and community development.

Our perspective on the Low-Income Housing Tax Credit, therefore, is as a dedicated, experienced, and -- we believe -- effective catalyst for low-income housing and neighborhood revitalization in communities nationwide. We enthusiastically supported the enactment of the Credit and have worked hard to make it a useful tool for rehabilitating and building low-income housing.

How LISC Uses the Credit to Attract Corporate Investments

To attract investment based on the Credit, LISC has created a series of equity investment pools designed to appeal to large corporations. In 1987, we raised $14.25 million in investments from 13 corporations. A list of these corporations is attached. These funds have attracted an additional $45 million in private and public financing for 24 projects containing over 1,000 units of affordable housing. In 1988, we expect to raise an additional $50 million from corporations, which will attract an estimated $90 million more from other sources to produce 2,000 units of affordable housing.

In our experience, corporations participate in our equity investment pools for several reasons.

- First and foremost, they expect to receive a competitive market rate of return. We have generally not found corporations willing to accept a below-market return. The primary source of this return is the Low-Income Housing Tax Credit. Cash flows from low-income housing projects are negligible. Prospects for capital appreciation in most low-income neighborhoods are speculative at best. The Credit is absolutely essential to making these investments -- and therefore these projects -- possible.

- Second, LISC's extensive and successful track record with similar CDC projects has been important in assuring corporations that their investments will be prudently managed with minimal risk. Most of these corporations have had little experience with CDCs or low-income housing in distressed neighborhoods, and they have no interest in a day-to-day involvement in these activities.

- Third, these corporations recognize that inadequate low-income housing and neighborhood deterioration are important problems nationwide and in the communities where they operate. Few of the corporations we have attracted so far have been involved in real estate development -- let alone low-income housing -- as part of their normal business activities. While social concerns alone are not sufficient reason for them to invest in low-income housing, corporate leaders with a heightened sense of civic responsibility have been the most receptive to considering low-income housing an investment.

Projects in Which Investments Are Made

LISC is channeling the investment funds raised from corporations to projects sponsored by nonprofit housing development corporations, which generally are neighborhood-based. The typical project involves the acquisition and rehabilitation of one or more apartment buildings in low-income neighborhoods. On average, 80 percent of the units are low-income occupied. These projects are selected to fit into an ongoing neighborhood revitalization program, rather than as isolated, one-shot projects. Thus, each successive project not only provides a much needed source of low-income housing, but also bolsters other existing low-income housing in the neighborhood and sets the stage for subsequent projects.

For example, in New York City, LISC is working with ten CDCs and the City government on an unprecedented demonstration program to rehabilitate about 1,000 units of housing that the City has taken over for failure of their owners to pay property taxes. By allowing the City to take possession of these buildings, their owners have conceded that the private market cannot operate them profitably. All of these buildings are vacant, abandoned, and have been serious blighting influences on the already distressed neighborhoods where they are located. The City is turning these buildings over to the CDCs and is providing substantial construction and permanent mortgage financing at interest rates low enough to permit affordability by low-income tenants. The CDCs will substantially rehabilitate and manage the buildings. LISC is providing $25,000-$30,000 per unit -- or about one-third of total development costs -- in equity investment raised from corporations through its New York Equity Fund, as well as planning grants, technical assistance, and working capital to the CDCs. LISC will also coordinate development processing and packaging of individual projects. These projects are scheduled for occupancy in late 1989.

Recommended Changes

Our experience suggests that the Credit -- while far from perfect -- is a fundamentally useful tool under certain circumstances. We would offer several recommendations for improving both its effectiveness and its cost-efficiency.

- Our first recommendation is that Congress should act this year to extend the Credits to projects placed in service through 1992. Low-income housing projects take a long time to complete. It is common for two or three years to elapse from the time planning starts to the time the housing is ready for occupancy. As such, that projects must be completed by the end of next year to qualify for a Credit is fast becoming a serious problem. It is already too late to start planning a project now that will not be completed until 1990 or 1991 because there can be no assurance that Credits will still be available when the project is finished. Yet, developers and investors are only now beginning to understand how the Credit works. Because the Credit is new and complicated, many prospective participants are not willing to spend time learning about the Credit if it will be available for so short a period. If the Credit is to become a fully effective tool, there must be time to develop a steady pipeline of projects, and developers must be confident that the Credit will be available when projects are completed. States and localities, nonprofit and for-profit developers, business corporations, private lenders, and foundations all are ready to join with the federal government to provide low-income housing, but the federal government must be a faithful and reliable partner. Turning the Credits on and off is no way to run a housing policy.

- Second, we recommend that Congress remove the penalties currently imposed on projects that combine the Credit with tax-exempt financing or federal grants and below-market loans. Virtually every Credit project requires some other form of public subsidy to make it work. The Credit is simply not large enough to make projects economically feasible by itself, given what we believe are appropriately rigorous low-income targeting standards. The reason is simple mathematics. Rents must be low both to be affordable and to meet the rules of the Credit. Once operating costs are paid, only a small mortgage can be carried at prevailing market interest rates. Some additional subsidy is needed to fill the financing gap. The limited availability of other of public subsidies is perhaps the most important obstacle LISC faces in making projects workable with the Credit.

- Third, it is extremely difficult for individual investors to utilize the Credit effectively because of passive activity loss/credit restrictions. The restriction on individual investors was one of the factors that led us to pursue corporate investors. So far, at least, we have succeeded in attracting corporate investors. However, the newness of corporations to these investments makes us cautious about the eventual prospects for this approach. Corporations require a great deal of education before they are willing to invest. Moreover, it is not at all clear how many corporations will be willing to invest in these projects, or whether the corporations that invest once will do so again and again. While we continue to pursue them, corporations may prove to be a very limited source of equity investment.

  Based on these concerns, it will be important for Congress to expand the range of potential investors in Credit projects.

  We recommend that Congress relax the passive activity loss/credit restrictions on individuals investing in projects that receive the Credits. I will let other witnesses explain in depth why this is necessary and how it might best be accomplished.

We further recommend that the Credit be made refundable to tax-exempt nonprofit owners of Credit projects. As noted earlier, CDCs and other nonprofits cannot now own projects if the Credit is to be used, but are compelled to seek profit-motivated investors, usually through syndication. Making the Credit refundable to tax-exempt sponsors would enable them to by-pass the syndication process entirely. There would be three important benefits. First, the effectiveness of the Credit would be greatly increased at no additional cost to the federal government. Almost the entire Credit amount could be used to pay for housing, since it would no longer be necessary to pay substantial rates of return to attract investors or to pay syndication fees. Second, assembling the financing for projects would be much simpler, faster, and more efficient if syndication were not necessary, especially on small scale projects. Third, and perhaps foremost, tax-exempt nonprofit sponsors could retain permanent control of the property and preserve the housing for low-income use beyond the 15-year compliance period. Investment partnerships formed to own the projects are legally free to convert the property to high-income use at the end of 15 years. As housing markets become increasingly tight, the pressures to convert low-income housing to high-income use will continue to rise. I know that you will address this important problem as it relates to HUD-assisted housing in your hearings tomorrow. Making the Credit refundable to tax-exempt owners would reduce the prospective loss of scarce low-income housing 15 years from now.

- We urge Congress to pass a technical corrections bill that incorporates provisions affecting the Low-Income Housing Tax Credit that were approved by the House Ways and Means Committee and the Senate Finance Committee last year. While we have succeeded in using the Credit, the law as enacted in 1986 is far from perfect. Numerous changes of a primarily technical nature are needed to make the credit more effective and easy to use.

  While LISC generally supports the entire package of technical corrections, one change in particular is needed to make the state allocation set-aside for nonprofit sponsored projects workable. For purposes of this set-aside, the amendment would define qualified nonprofit organizations to include any organization that is wholly owned by a qualified nonprofit organization. The current definition requires that qualified nonprofit organizations must themselves be tax-exempt. However, other parts of the tax code applicable to tax-exempt entities make it extremely difficult -- if not impossible -- for them to act as general partners in limited partnerships. For this reason, tax-exempt nonprofits generally participate in tax credit projects through subsidiaries that act as general partners in the owning partnerships. It is essential that the state allocation set-aside for nonprofits accommodate this practice. Otherwise, the set-aside will have little usefulness.

- At-risk provisions that reduce the Credit on projects receiving below-market loans from qualified nonprofit lenders should be removed. No such penalty applies to below-market loans made by states and localities. There is no reason to penalize a project merely because it receives a below-market loan from a nonprofit lender. On the contrary, Congress should affirmatively encourage such assistance.
- Owners should be able to commit themselves at any time to transfer Credit projects to qualified nonprofit organizations at a price lower than fair market value. Such commitments would enable nonprofit sponsors to use Credit projects to serve low-income people beyond the 15-year compliance period.
- The requirement that Credit projects be available for general public use should not preclude housing reserved for the homeless, the elderly, the physically or mentally disabled, or other special needs populations. Housing for these kinds of people is acutely needed in many communities. The Credit should be flexible enough to accommodate the full range of local housing needs. Prohibitions against using the Credit for nursing homes, sanitariums and other such facilities could be retained.

This concludes my testimony. I would be happy to answer any questions.

CORPORATE INVESTORS IN LISC'S
NATIONAL EQUITY FUND 1987 PARTNERSHIP

ARCO

Citicorp

The Continental Corporation

Eastman Kodak Company

The Equitable Financial Companies

First Interstate Bank of California

Great Western Financial Corporation

Hallmark Cards, Inc. (VHI Ltd., Subsidiary)

Payless Cashways, Inc.

J.C. Penney Company, Inc.

The Stanley Works

Transamerica Occidental Life Insurance Company

USG Corporation

Chairman RANGEL. Thank you, Mr. Ditton. Mr. Dale.

STATEMENT OF LARRY H. DALE, SENIOR VICE PRESIDENT FOR MULTIFAMILY ACTIVITIES, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. DALE. Thank you, Mr. Chairman. I appreciate the opportunity to appear here today to review Fannie Mae's early experience with the low-income housing tax credit and to review future prospects for the credit.

Fannie Mae is a privately owned corporation with a congressional charter that dedicates us exclusively to supporting residential finance, both single-family and multifamily. Through our purchases of loans in the secondary mortgage market and our issuance of mortgage-backed securities, we finance about one out of every eight mortgages in the United States. We help make housing more affordable for more Americans, particularly moderate and middle-income families.

Fannie Mae is also developing a range of programs which help to finance decent affordable shelter for low- and moderate-income families. In 1987 we created an Office of Low- and Moderate-Income Housing to focus and expand our efforts on behalf of the Nation's needier citizens.

Our new office has made active use of the low-income housing tax credit, among other financing tools. Last year alone we invested more than $1½ billion in a variety of low- and moderate-income housing programs. These investments will help house nearly 35,000 low- and moderate-income families.

Our special efforts take several forms. For example, we are expanding aggressively our community lending programs. We are co-sponsoring a number of studies to develop models for employer-sponsored affordable housing. In addition, we work with State and local housing finance agencies to reduce the cost of mortgages financed with tax-exempt bonds by purchasing these tax-exempt mortgage revenue bonds. Fannie Mae's involvement reduces the agency's issuing cost, thus allowing them to pass along savings to first-time home buyers. The authority for such bond issuances, which is due to sunset at the end of 1988, serves an extremely valuable purpose. We encourage the subcommittee and the full Congress to extend mortgage revenue bonds.

We also believe that the ability of Fannie Mae and other corporations to purchase these bonds magnifies their benefits for lower income home buyers.

Our special programs mirror expanded efforts by states, localities, nonprofit organizations, and other corporations to address the housing needs of low- and moderate-income households. The low-income housing tax credit has been a central part of Fannie Mae's housing affordability efforts. We are committed to demonstrating the value of the credit and to encouraging other corporations to make use of it.

In 1987 we committed to invest more than $40 million in housing that will qualify for tax credits, and we expect that figure to grow substantially during this year. The investments we made last year reflect the range of housing circumstances to which the credit can be applied. Our largest commitment to date is for an investment of $28 million in New York City to help finance the rehabilitation of up to 1,000 units of abandoned housing in targeted neighborhoods. In this project, the Enterprise Foundation is giving technical assistance to New York's community groups, the city of New York is making available city-owned property at nominal cost, and both the city and the state are providing mortgage financing on concessionary terms.

We already have identified two projects for financing, and we are eager to finance others.

Another tax credit investment involves renovating an inner-city YMCA in Pittsburgh to provide 270 units of single-room occupancy dwellings as transitional housing for the homeless. This project enjoys local government support and financial assistance from a number of nonprofit foundations.

We are also participating in a limited partnership with Montgomery County's Housing Opportunities Commission, and the investment arm of the Potomac Electric Power Co. The county is acquiring 32 single-family homes through an inclusionary zoning program and is making them available as low-income rental units by using the tax credit.

In addition, we have invested in major low-income housing developments in Cleveland and Baltimore with profit-motivated developers. These investments are supporting the renovation of 820 units in Cleveland and 78 units in Baltimore.

This year Fannie Mae is continuing to pursue aggressively tax credit investment opportunities. By the end of the year we are confident that our total commitment to tax credit investments will have more than doubled, and we will have investments in all areas of the country.

Although improvements can be made, the tax credit is already an important tool for helping low-income families afford decent rental housing. Our strong support for the credit reflects this basic belief.

In reviewing the possible changes to the credit, we believe the first priority should be making the credit permanent. The credit can help solve the growing shortage of affordable rental units for low-income families only if it is structured to provide a steady stream of investment opportunities. Because of startup delays and uncertainties associated with any new effort as well as the substantial learning curve associated with corporate investment in low-income housing, ending the program in 1989 will preclude any significant addition to the lower income housing stock.

We also fully support the concept of legislation such as H.R. 3663, sponsored by yourself and Representative Frank. That bill would provide additional tax incentives to encourage the preservation of existing federally or State-assisted rental housing for low-income use. Prepayment of these loans with the potential loss of such housing for low-income families is a very serious and immediate housing problem. If supplementing the tax credit can help preserve this housing for lower income families, we all should jump at that opportunity.

At the same time, we believe the basic concept of H.R. 3663 must be accompanied by an increase in credit authority to the States.

Without additional funding H.R. 3663 could have the unintended effect of substituting preservation of existing subsidized housing for new housing initiatives, when both are sorely needed.

In summary, Fannie Mae's experience with the low-income housing tax credit has proven that this vehicle offers a potentially powerful tool to help lower income families afford decent rental housing. We believe that our ability to use the tax credit effectively will encourage other companies to join in the effort to improve housing resources for lower income families and to leverage private resources. Providing permanent status for the credit and supplementing it with incentives such as those included in H.R. 3663, and added credit allocations to the state can help make substantial inroads towards solving the problem of a shrinking supply of this housing. We should not settle for anything less.

Thank you, Mr. Chairman, I would be happy to answer any questions.

[The statement of Mr. Dale follows:]

STATEMENT OF LARRY H. DALE, SENIOR VICE PRESIDENT, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. Chairman and members of the Subcommittee:

My name is Larry Dale. I am Senior Vice President for Multifamily Activities at Fannie Mae. Fannie Mae is a privately owned corporation with a federal charter. We are dedicated exclusively to supporting residential finance--both single-family and multifamily. We do this by purchasing loans from lenders in what is known as the secondary mortgage market, and by issuing securities that are backed by residential mortgages.

Fannie Mae is the nation's largest portfolio investor in mortgages, with $93.5 billion of mortgages outstanding at the end of 1987. Fannie Mae also issues and guarantees mortgage-backed securities (MBS), with $139.9 billion outstanding at year end 1987. Together, Fannie Mae's portfolio purchases and MBS finance about one out of every eight mortgages in the United States.

We help make housing more affordable for all Americans, particularly moderate-and middle-income families. In addition, during the past year we have expanded our multifamily financing activities and increased our programs designed to improve the access of low-income families to affordable, decent housing--through the low-income housing tax credit and in other ways. We are proud of our record, but we recognize the need to do more.

I appreciate the opportunity to discuss Fannie Mae's early experience with the low-income housing tax credit and some of our thoughts on the future prospects for the credit. Fannie Mae strongly supports the credit, and I commend Chairman Rangel for his leadership in creating the credit in 1986, and for undertaking this timely review of the issue.

The credit--created in the 1986 tax reform legislation--represents an important innovation in housing assistance for lower-income families. It provides a significant new financial incentive for the construction, rehabilitation, and preservation of lower-income rental housing. At the same time, it shifts the focus of decision-making about housing subsidies from the federal government to state governments, acting in partnership with localities, nonprofit organizations, and private corporations like Fannie Mae. The tax credit is, and will continue to be, an important tool in meeting the nation's low-income housing needs.

In areas with severe affordability problems, states, localities, and corporations have increasingly recognized the housing problems of low-and moderate-income families as an area of concern. Additionally, corporations increasingly have been concerned about housing the work force upon which they rely. As a result, corporations have begun participating with state and local governments in trying to develop solutions.

As a corporation dedicated exclusively to housing, Fannie Mae is developing a range of programs which help to finance decent, affordable shelter for low- and moderate-income families. Our use of the low-income tax credit is one example of that effort. These investments are especially fruitful because our participation and experience can magnify the efforts of our partners and encourage other corporations to participate in a similar manner.

My remarks today focus on three areas affecting the Subcommittee's review of the tax credit:

o First, how have the housing needs of low-income families in the United States changed? And how has housing policy changed to accommodate these needs?

o Second, what has been the role of public-private partnerships in meeting lower-income housing needs, and how has Fannie Mae participated in this process. including use of the low-income housing tax credit?

- Third, what changes should be made in the tax credit? In particular, how can the tax credit help to preserve existing multifamily housing dedicated to low-income families?

LOW-INCOME HOUSING NEEDS AND THE CHANGING NATURE OF FEDERAL HOUSING POLICY

The nation's lower-income households face severe problems in finding affordable, decent housing. This has been widely documented.

While progress has been made over the past several decades in improving housing conditions, many Americans remain ill-housed, or must pay significant proportions of their incomes for housing. Between 1940 and 1970, the percentage of all households living in units that were either physically dilapidated or lacked complete indoor plumbing facilities declined from almost 49 percent to just over 7 percent. Nonetheless, according to the Congressional Budget Office (CBO), in 1983, nearly 10 million households were living in dwelling units requiring rehabilitation, or were paying more than 50 percent of their income for shelter.

The housing problems that remain are heavily concentrated among lower-income households. As of 1983, 29 percent of all households with incomes equal to or less than 80 percent of the area median income were either living in physically inadequate housing, were paying more than one-half their incomes for housing, or experienced both conditions. Among households with incomes equal to or less than 50 percent of the local median, over 40 percent suffered from these conditions. These circumstances are unacceptable.

For these lower-income households, the supply of available and affordable rental housing is shrinking, even as the need for such housing expands. This dilemma has accompanied a significant increase in the number of Americans living at the official "poverty level" (as defined by the Census Bureau for 1987, $11,612 for a family of four), and a loss of real buying power. Since 1980, the poverty population has climbed from 12 to almost 14 percent of the total, numbering about 35 million people in 1987. Between 1974-1983, the poorest 20 percent of American households experienced a decline in real income of 4 percent. A study by the National Association of Home Builders (NAHB) found real structure rents (excluding utilities) increased by roughly 10 percent during this period.

These forces have combined to reduce dramatically the supply of affordable housing for lower-income renters, and the gap is likely to widen further. A 1987 study by the Neighborhood Reinvestment Corporation projected a shortfall of 7.8 million affordable units over the next 15 years, affecting 18.7 million Americans. Although more households are receiving housing assistance today than 10 years ago, the need remains acute and is likely to grow in the future.

The Changing Nature of Federal Housing Policy

Federal policies to address the nation's housing needs have evolved over a long period; they feature a combination of direct spending programs, targeted tax provisions, and credit support.

Since the 1930s, federal policy has assisted homeowners by combining the tax deduction for mortgage-interest payments, along with federal mortgage insurance to allow households of modest means to acquire low down-payment financing for home purchases. Relatively few federal resources are directed toward spending programs to reduce the cost of purchasing homes for low- and moderate-income households.

Rental assistance has taken a different form. Since the 1930s, the federal government has provided various types of subsidies either to reduce the cost of constructing or financing rental housing projects that are set aside for occupancy by lower-income tenants, or to pay a share of the rent for households living in these apartments. For the past several decades, tax policy supplemented direct spending programs with special provisions designed to encourage the construction of new rental housing.

In recent years, the focus of rental assistance has changed significantly. Beginning in the late 1970s, we saw a sharp and accelerating reduction in the amount of direct federal assistance provided each year to assist additional lower-income renters. Also, the emphasis in federal assistance has shifted from project-based subsidies to housing vouchers and similar forms of aid which subsidize households living in dwellings of their own choosing. While vouchers work when apartments are available, they are much less effective in tight markets.

The Low-Income Housing Tax Credit as an Instrument of Federal Tax Policy

The 1986 Tax Reform Act ushered in an important new chapter in federal housing assistance. The Act sharply curtailed benefits designed to encourage development of low-income rental housing, such as accelerated depreciation. This resulted in a substantial reduction in investment in multifamily housing. We see the numbers monthly when the Commerce Department reports housing starts statistics. The one bright light for affordable rental housing in the Act was the creation of tax credits for corporations and some individuals who invest in low-income rental housing. The tax credit gives states decision-making authority to allocate credits. Also, it encourages government to join with private corporations and nonprofit organizations in structuring financing for individual projects.

PUBLIC-PRIVATE PARTNERSHIPS IN HOUSING AND FANNIE MAE'S EXPERIENCE WITH THE LOW-INCOME HOUSING TAX CREDIT

The shift in federal policies from project-based subsidies to individual assistance--in the face of persistent housing needs--has resulted in an increasing reliance on housing initiatives at the state and local level, and on partnerships between the public and private sectors.

Some states and cities - Massachusetts and Philadelphia, for example -- have set up "land banks" of abandoned properties for future housing. Others are revising building codes and zoning regulations that drive up housing costs. City-based, public-private partnerships have sprung up across the country, including Pittsburgh, New York, Chicago, San Francisco, Oakland, and Boston. The Boston Housing Partnership--an alliance of city, corporate and non-profit entities--has rehabilitated 700 units since 1983 and is working on another 1,000 units. The Enterprise Foundation and the Local Initiatives Support Corporation (LISC) were established to provide seed money and technical assistance to community nonprofit developers.

Fannie Mae is proud of the role it is playing in this emerging process. In 1987, we created an Office of Low- and Moderate-Income Housing to help focus and expand Fannie Mae's efforts to increase housing opportunities for our nation's neediest citizens. Last year alone, we invested more than $1.5 billion, and committed to invest additional amounts, that will help house nearly 35,000 low-and moderate-income families. We have provided each member of the Subcommittee with a copy of a report describing our low- moderate-income housing initiatives in more detail.

Our special efforts take several forms. For example, we are expanding aggressively our community lending programs, in which we provide primary mortgage financing, associated with subsidized secondary financing provided by a state, city or nonprofit organization. Another initiative is our co-sponsorship of a number of feasibility studies of employer-sponsored affordable housing efforts. Typically, these programs involve joint efforts with local governments, major universities, or major employers in an area to provide solutions to severe housing supply and affordability problems.

We also have worked with state and local housing finance agencies to reduce the cost of mortgages financed with tax-exempt bonds. This has included purchasing tax-exempt mortgage revenue bonds, which reduces the agencies' issuing costs, thus allowing them to pass along savings to first-time home buyers. The authority for such bond issuances, which is due to sunset at the end of 1988, serves an extremely valuable purpose for first time home buyers. We strongly encourage the Subcommittee and the full Congress to extend mortgage revenue bonds.

Fannie Mae's direct bond purchases have maximized the benefits of these bond to low- and moderate-income home buyers. Enactment of a more limited "de minimis" rule would effectively preclude Fannie Mae from using its remaining authority to provide this type of support for first-time home buyers. I realize we may be discussing this more in the next several months, but I want to tell you today how valuable for America's home buyers it is for corporations like Fannie Mae to be able to purchase directly tax-exempt state and local housing agency financing bonds.

Fannie Mae's Experience With the Low-Income Housing Tax Credit

The low-income housing tax credit has been central in our housing affordability efforts. Fannie Mae is committed to demonstrating the value of the low-income housing tax credit program and to encouraging other corporations to make use of it. In 1987 alone, we committed to invest more than $40 million in housing that will qualify for tax credits, and we expect that figure to grow substantially during this year.

The investments we made last year reflect the range of housing circumstances to which the credit can be applied. Our first tax-credit investment involves the renovation of an inner-city YMCA in Pittsburgh which is supporting 270 units of single-room-occupancy dwellings as transitional housing for the homeless. This project enjoys local government support and financial assistance from a number of nonprofit foundations.

We also committed to invest $28 million in New York City to help finance the rehabilitation of up to 1,000 units of abandoned housing in target neighborhoods. Fannie Mae works with the Enterprise Foundation, which is assisting New York's community groups to identify appropriate structures and helping them structure the transactions. The city of New York is making available city-owned properties at nominal cost, and both the city and the state are providing mortgage financing on concessionary terms. We already have identified two projects for financing, and we are anxious to finance others.

We announced recently another transaction in Montgomery County, Maryland, participating in a limited partnership with that county's Housing Opportunities Commission (HOC) and the investment arm of the Potomac Electric Power Company (PEPCO). Montgomery County is acquiring 32 single-family homes through an inclusionary zoning program and is making them available as low- and moderate-income rental units by using the tax credit.

We also are working as limited partners in major low-income housing developments that are sponsored by profit-motivated developers in Baltimore and Cleveland. Our investments are supporting 820 units of renovation in Cleveland, and 78 units of rehabilitation in Baltimore.

During this year, Fannie Mae is continuing to pursue aggressively tax-credit investment opportunities. By the end of this year, we are confident that our total commitment to tax-credit investments will have more than doubled, and we will have investments in all areas of the country.

CHANGES TO THE TAX CREDIT

The Chairman and CEO of Fannie Mae, David Maxwell, serves as the Vice Chairman of the National Housing Task Force, under the leadership of James Rouse, and with direction from Senators Alan Cranston and Alfonso D'Amato. The Task Force soon will report its recommendations which, I'm reasonably sure, will deal with the low-income housing credit, among other issues. Although improvements can be made, it is clear that the tax credit--barely a year old--is already an important tool for helping low-income families afford decent low-income rental housing. Our strong support for the credit reflects this basic belief and our positive experience working with it.

In reviewing possible changes to the credit, we believe the first priority should be ensuring its availability on a permanent basis. The credit can help solve the growing shortage of affordable rental units for low- and moderate-income families only if structured to provide a steady stream of investment opportunities. Because of start-up delays and uncertainties associated with any new effort, as well as the substantial "learning curve" associated with corporate investment in low-income housing, ending the program in 1989 will preclude any significant addition to the lower-income housing stock.

We also fully support the concept of legislation such as H. R. 3663 sponsored by Chairman Rangel and Representative Barney Frank. That bill would provide additional tax incentives to encourage the preservation of existing federally- or state-assisted rental housing for low-income use. Fannie Mae has participated in task forces and other efforts to address the possible loss of housing stock through prepayments of these mortgages. Prepayment of these loans, with the potential loss of such housing for its intended beneficiaries, is a very serious, immediate housing problem. If supplementing the tax credit can help preserve this housing for lower-income families, we should jump at the opportunity.

We believe that using the credit to encourage preservation of low-income housing must be accompanied by an increase in credit authority to the states. Without additional funding for the credit, H. R. 3663 could have the unintended effect of substituting preservation of existing subsidized housing stock for the many new housing initiatives which are currently using the credit and adding new low-income units to the stock, when both are sorely needed. Given the tremendous pressures on our supply of low-income housing, it is critical to encourage both preservation and new construction.

CONCLUSION

Fannie Mae's experience with the low-income housing tax credit has proven that this vehicle offers a potentially powerful tool to help low-income families afford decent rental housing.

The tax credit is particularly important because it represents a unique means to channel the profit motive into helping our neediest families. In that way, it links the most fortunate in our nation with the least fortunate.

Fannie Mae believes that our ability to use the tax credit effectively will encourage other companies to join in the effort to improve housing resources for lower-income families and to leverage private resources. Providing permanent status for the credit and supplementing it with incentives such as those included in H. R. 3663 and added credit allocations to the states, can help make substantial inroads toward solving the problem of a shrinking supply of this housing. We should not settle for anything less.

Thank you, Mr. Chairman. I am happy to answer any questions that you or other members of the Subcommittee may have.

Chairman Rangel. Could any of you tell us what kind of a rate of return you promise or the corporate structure is demanding in these areas?

Mr. Dale.

Mr. Dale. I can't give you a precise number.

Chairman Rangel. Roughly.

Mr. Dale. In round numbers it's probably 15 percent, but it varies very substantially from transaction to transaction, based upon the risks and the rewards and the potential——

Chairman Rangel. Let me say this. I want to thank you for your past contributions to the Joint Committee and the House Ways and Means Committee and Senate Finance Committee, as well as for your testimony today. You know that we rapidly put together this as an emergency measure when the reform was wiping out the passive losses. We didn't know then, nor do we know now, exactly which is the best route to go—and it is true that time has run out on us, one-third of the package is gone—and I am going to try my darndest to get it extended.

But do you people—I know some of you work with Senator D'Amato—do you know each other and do you meet at different meetings? I mean, you didn't meet for the first time today, did you?

Mr. Ross. Some of us did.

Chairman Rangel. Because what I am suggesting is this, that I hope that we can set up a team, starting with you four, to meet at some later date. Because we don't have legislation on the floor, many of the Members returned to their home districts and we didn't get the turnout that I would have hoped we would have gotten from the subcommittee. Dan Rostenkowski provided the leadership in making certain that we got something. Now comes the question, as we try to improve it, Members have to understand that it is working, it can work better, and that we should be able to have some continuity or something that investors can depend on. In addition to that, I think we in the Congress—I saw the prestigious list that someone had, I guess it's Mr. Ditton, of the corporations that had some sense of community responsibility—there's no question in my mind that we can establish some good will, those of us in the Congress, by encouraging them to get involved, especially before the next tax bill.

But I hope that I can get some kind of commitment that you will try to get together at a definite meeting to meet with Members of the subcommittee, if not the full committee—and I will ask Jon Sheiner to meet with you. I have to run now. But I want to thank you for what you've done, and also look forward to working with you individually, and the outfits. I have many, many more questions, but I have to meet with the Speaker on some of these issues that we are trying to get in a package, and so thanks again. And the committee stands adjourned.

[The hearing was adjourned at 2:28 p.m.]

PRESERVING THE STOCK OF LOW-INCOME HOUSING

THURSDAY, MARCH 3, 1988

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:20 a.m., in room 1100, Longworth House Office Building, Hon. William J. Coyne presiding.

Mr. Coyne. I would like to begin the hearing by reading the opening statement of Chairman Rangel.

Today, the Subcommittee on Select Revenue Measures of the Committee on Ways and Means will continue with its second day of public hearings on the role of tax policy in the development and preservation of low and moderate income housing.

Yesterday, we took testimony on the low-income housing credit created by the Tax Reform Act of 1986. Today, we will take testimony on the role of tax policy in preserving the stock of low and moderate income multifamily housing.

Earlier in this Congress, Congressman Barney Frank, who will testify here later today, and Chairman Rangel, introduced H.R. 3663. This legislation is designed to encourage the preservation of existing federally and State-aided multifamily housing for low and moderate income families.

Our concern is that the owners of low and moderate income housing developments will exercise provisions of their mortgages, allowing them to prepay their debt and relieve themselves of the restrictions requiring them to rent to low and moderate income tenants.

As these mortgage provisions begin to become effective the nation could begin to lose a significant volume of apartments for low and moderate income tenants.

With the decline in Government support for low and moderate income housing, the results could be very devastating.

The General Accounting Office has estimated a loss of between 240,000 and 890,000 units of low and moderate income federally supported housing by 1995, if owners continue to prepay their mortgages.

The problem extends to the States. In New York, the home State of the chairman, and in other States, there are housing assistance programs with similar mortgage provisions.

The most notable program in New York is the Mitchell-Lama program. While Gov. Mario Cuomo has acted to stem the tide of Mitchell-Lama conversions and to preserve the affordable housing for moderate income families, the State needs help from Washington to provide reasonable incentives for landlords to encourage them to maintain their projects for the groups they were originally intended to assist.

We are also concerned about the preservation of cooperative housing for low and moderate income families. Like their rental counterparts, many Government-assisted housing co-ops can prepay their mortgage and convert their project to a market-rate development.

While conversion might result in windfall profits for the current cooperators, it would mean that the units would no longer be available to low and moderate income families.

The subcommittee recognizes that the recently enacted Housing and Community Development Act of 1987 addresses the problem of prepayments for certain Federal housing programs.

Congress expressed in the legislation its concern over the potential loss of low income housing units and the grave harm that the loss would create.

The legislation recognizes that the adequate supply of low income housing has depended upon and will continue to depend upon a strong long-term partnership between the public and private sectors that accommodates a fair rate of return on investment.

It further recognizes that the reductions in the Federal housing budget and in tax benefits previously associated with low income housing have increased the incentives for the private sector to withdraw from the production of low income housing.

Therefore, Congress declared that efforts to preserve this housing for low income tenants must be tailored to the unique financial and market conditions of individual projects.

The purpose of this day's hearing is to see what Congress can do with tax provisions affecting housing to help complement the Housing Act provisions and to tailor additional opportunities for encouraging the preservation of low and moderate income housing.

We will also consider the problems facing low and moderate income cooperative housing. The subcommittee expects to learn what incentives might be available to encourage cooperators to continue operating their co-op for the benefit of low and moderate income families.

The subcommittee expects the witnesses before it today will share with it the depth of the conversation problem facing us today and the solutions they may have for meeting the crisis.

I am told that Mr. Frank will be here about 11 or 11:30, and so we will begin with—Barbara Kennelly has a statement.

Mrs. KENNELLY. Mr. Chairman, unfortunately, I was tied up in the Intelligence Committee most of yesterday and could not be here to listen to testimony. However, I do have copies of that testimony and will be reading it over the weekend.

I do want to express my concerns about the functioning, or lack thereof, of the low-income tax credit.

We have a 4-percent vacancy rate in Hartford, Conn., my dis[illegible]ct, which also happens to be the fourth-poorest city in America.

Everyone is being squeezed, and, naturally, the poor and the near-poor are squeezed the hardest.

I understand and know so well that no one has done more for low-income housing in Congress than the chairman of this subcommittee, and I commend Mr. Rangel for having these hearings and I commend him for his leadership.

But we all know the low-income tax credit has a number of strikes against it especially that it is so new that considerable time and effort has been spent by the housing community in trying to understand and improve it. I think these hearings, therefore, are very necessary right now, so we can determine if in fact this tax credit can work, and if in fact it cannot work, what we can do, down the line.

But I am most interested because I have been a proponent of the historic tax credit well before I went on the Hartford City Council, let alone came to Congress.

We have situations within my own area where projects stopped because of what happened in the tax reform bill of 1986.

So, Mr. Chairman, I am glad we are having these hearings because I feel that this is a question that we cannot let simmer too long, or there will be few historic rehabilitation projects going on. There will be few low-income housing going on, which is more important. I have to give you the caveat that no historic rehabilitation hurts housing since it has been used so well in relation to housing for the low-income people. So I think there is a dual purpose here in these hearings, but most important, obviously, is low-income housing. I salute the chairman, Mr. Rangel, for having these hearings, and thank you for chairing them today.

Mr. COYNE. Thank you, Mrs. Kennelly.

We will begin with the first witness, Thomas Demery, Assistant Secretary for Housing.

STATEMENT OF HON. THOMAS T. DEMERY, ASSISTANT SECRETARY FOR HOUSING, FEDERAL HOUSING COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. DEMERY. Thank you very much.

I am pleased to be here today to share with you some thoughts on techniques relating to the preservation of low-income stock.

I can see by the panel around me, and those who will follow, that you will hear from a wide range of experts in this field.

As FHA Commissioner, my job brings me face to face, almost on a daily basis, with the issues of mortgage prepayments and potential loss to the inventory due to expiring section 8 contracts.

When considering the various aspects connected with these subjects, I believe it is important to seek a balanced and informed point of view. No one sector, be it an agency, tenant group, State or local body of Government, syndicator, developer, has all the answers.

Each can contribute a valid viewpoint which needs to be considered when developing the composite solution. At HUD, the agency most immediately immersed in the daily fallout from prepayments, we have worked very hard to develop a sound public national policy that is broad and flexible enough to be consistently applied, while, at the same time, sensitive to special needs of a specific situation.

The cornerstone of this policy is a functioning partnership between all of the previously mentioned sectors working together to solve a common problem.

Tools such as rent increases, vouchers, certificates, moderate rehab, section 8, secondary financing, tax abatement, tax credits, and nonprofit transfers are all possible responses to be considered.

A more detailed explanation is contained in my written testimony. It is my view that public policy should continue to be flexible so we can tailor solutions instead of finding the closest thing on the rack which appears to fit, and then being stuck with it.

Proper information for problem definition is the second key element. Prepayment and preservation are emotional issues, and the actual number of units at real risk is nowhere near as high as to conclude that we are on the verge of a huge crisis.

I have heard it mentioned in the past that the potential to displace up to 1.8 million low-income Americans is looming right around the corner, and while there is a composite number of 1.8 million units receiving subsidy today, that does not necessarily mean all the tenants affected by that subsidy will in fact be displaced.

My approach to problem-solving is to reduce concerns that are not founded in fact, to enlist all affected parties to contribute to the solution, and to use creatively the tools and resources available to achieve the greatest benefit or result.

I think a good example of this is the 600,000 units of section 221(d)(3) and 236 units considered at risk of loss because of expiring use restrictions.

A closer examination of that 600,000 unit number reveals that 241,000 of those units are legally ineligible to prepay prior to the term of their mortgage without HUD approval.

An additional 200,000 units, because of local market conditions, are unlikely to prepay due to reasons of project feasibility.

In other words, nearly 75 percent of the 600,000 units potentially at risk of loss are in fact reasonably secure as a low-income resource for the 40-year term of the mortgage.

For those mortgages which have prepaid, the issue of potential tenant displacement has been successfully resolved, on a case by case basis through the use of vouchers, certificates and community assistance.

I have submitted in my written testimony rather lengthy and detailed explanations of the various programs that I just referenced, as well as some statistics. I want to give the panel and the subcommittee sufficient time to ask any questions or raise any issues they may have, so I would like to terminate my summary remarks, and turn to any questions.

[The statement of Mr. Demery follows:]

STATEMENT OF THOMAS T. DEMERY, ASSISTANT SECRETARY FOR HOUSING, FEDERAL HOUSING COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

GOOD MORNING. I AM PLEASED TO BE HERE TO SHARE WITH THIS COMMITTEE THE DEPARTMENT'S THOUGHTS ON THE HOUSING PRESERVATION PROBLEMS FACING THE COUNTRY NOW AND INTO THE NEXT DECADE.

I WOULD LIKE TO PRESENT MY TESTIMONY IN THREE PARTS. FIRST, I WILL PROVIDE A BRIEF DESCRIPTION OF THE CURRENT LOW INCOME HOUSING PORTFOLIO AND THE PROGRAMS UNDER WHICH THAT HOUSING WAS CREATED. SECOND, I WILL DISCUSS HOW SOME OF THOSE UNITS COULD BE REMOVED FROM THE PORTFOLIO AND CONVERTED TO USES OTHER THAN LOW INCOME HOUSING. FINALLY, I WILL IDENTIFY SOME TOOLS THAT COULD POSSIBLY REDUCE THE POTENTIAL LOSS OF UNITS FROM THE LOW INCOME HOUSING STOCK.

THE CURRENT STOCK

THE ATTACHMENTS TO MY STATEMENT DESCRIBE THE CURRENT STOCK OF ASSISTED HOUSING. WHILE THIS PORTFOLIO TOTALS ABOUT 4.3 MILLION UNITS, THE PRESERVATION ISSUES WE ARE ADDRESSING TODAY RELATE PRIMARILY TO THE APPROXIMATE 1.5 MILLION UNITS IN ITEMS 1 THROUGH 4 OF THE FIRST ATTACHMENT. THESE UNITS WERE BUILT IN THE SIXTIES AND SEVENTIES, FINANCED WITH PRIVATE CAPITAL AND ASSISTED THROUGH TWO FORMS OF DIRECT FEDERAL SUBSIDIES: INTEREST REDUCTION PAYMENTS AND TENANT-BASED SUBSIDIES. APPROXIMATELY TWO-THIRDS OF THESE UNITS WERE ALSO DEVELOPED WITH FHA MORTGAGE INSURANCE.

PLEASE LET ME GIVE YOU A BRIEF DESCRIPTION OF HOW THESE PROGRAMS OPERATE. I THINK SUCH A DESCRIPTION WILL HELP YOU TO UNDERSTAND THE PRESERVATION PROBLEMS WE ARE FACING TODAY AND TO EVALUATE OPTIONS FOR ADDRESSING THOSE PROBLEMS.

- INTEREST REDUCTION PAYMENTS ARE PAID TO MORTGAGEES ON BEHALF OF SECTION 236 AND BMIR PROJECTS. IN THE BMIR PROGRAM, THE SUBSIDY WAS PROVIDED AS A ONE-TIME BUYDOWN THAT GAVE THE PROJECT A 40-YEAR MORTGAGE AT 3%. IN THE SECTION 236 PROGRAM, THE INTEREST SUBSIDY IS PAID MONTHLY OVER THE LIFE OF THE MORTGAGE. HUD PAYS THE MORTGAGEE THE DIFFERENCE BETWEEN DEBT SERVICE DUE AT THE MARKET RATE IN EFFECT WHEN THE MORTGAGE WAS MADE (GENERALLY BETWEEN 6 AND 9 PERCENT) AND THE DEBT SERVICE THAT WOULD BE REQUIRED AT 1%.

    - THESE INTEREST REDUCTION SUBSIDIES ENABLE PROJECT OWNERS TO CHARGE LOWER RENTS AND STILL COVER REASONABLE COSTS OF OPERATING THESE PROJECTS.

    - IN RETURN FOR THESE SUBSIDIES, PROJECT OWNERS AGREED TO BE RESTRICTED AS TO RATES OF RETURN AND USE OF THE UNITS. MORE SPECIFICALLY, OWNERS AGREED TO HOUSE LOW AND MODERATE INCOME FAMILIES, TO CHARGE THOSE FAMILIES ONLY THE SUBSIDIZED RENTS HUD FORMULAS DETERMINED AND TO PAY THEMSELVES ONLY A LIMITED RETURN - I.E, ANNUALLY, NO MORE THAN 6% OF THEIR ORIGINAL EQUITY. (NONPROFIT OWNERS, OF COURSE, RECEIVE NO DISTRIBUTIONS.)

-- The contractual documents on these projects provide that these rents and use restrictions generally will apply as long as the mortgage remains in place. However, these documents also provide that some owners may prepay these mortgages without HUD approval after 20 years. This prepayment right is generally available to limited dividend owners who do not receive rent supplement assistance and who have not otherwise agreed to give up or modify this right (e.g., in return for a workout). Nonprofit owners and limited distribution owners who receive rent supplement assistance may NOT prepay. These owners are "locked-in" to the rent and use restrictions for the 40-year term of their mortgages.

o Tenant-based subsidies are made in the Rent Supplement, Rental Assistance (RAP) and Section 8 programs. These subsidies generally equal the difference between the HUD-established rent for the unit and approximately 30 percent of the family income. These subsidies can be used alone or "piggybacked" on top of the interest reduction subsidies I just described. Projects developed under the 221(d)(3) Rent Supplement program and the 221(d)(4) Section 8 program receive only the tenant-based subsidy. Section 236 and BMIR projects may receive both interest reduction and tenant-based subsidies. Approximately 50% of the HUD-insured and HUD-held BMIR and 236 units benefit from both forms of subsidy. Tenant-based subsidies were made available to BMIR and 236 projects at which low income families could not afford even the reduced rents that resulted from the interest reduction subsidies.

-- In accepting tenant-based subsidies, owners agreed to let HUD limit rents to those necessary to cover reasonable operating costs or those dictated by HUD's market rent studies. Owners agreed to so do for the term of the subsidy contract. Contract terms vary by the type of subsidy. Rent supplement contracts have 40-year terms. RAP contracts continue for the life of the 236 mortgage. Section 8 contracts were written for 5, 15 or 20 year terms but owners of the 15-year contracts generally have the right to opt out at the end of each five-year increment.

-- While all forms of tenant-based subsidy still exist, Rent Supplement and RAP assistance is concentrated primarily in state agency financed, non-insured projects. At HUD insured and HUD-held projects, the tenant-based subsidy is now primarily Section 8. While Rent Supplement and RAP were previously used in insured and and HUD-held projects, in the early eighties we replaced those forms of tenant-based subsidy with Section 8.

INTENTIONAL
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THIS ASSISTED INVENTORY IS OWNED BY BOTH NOT-FOR-PROFIT AND PROFIT-MOTIVATED OWNERS. THE PROFIT-MOTIVATED OWNERS ARE PRIMARILY LIMITED PARTNERSHIPS. OBVIOUSLY, SOCIAL CONCERNS MOTIVATED THE NOT-FOR-PROFITS TO PARTICIPATE. IN CONTRAST, PROFIT-MOTIVATED OWNERS WERE ATTRACTED PRIMARILY BY THE SIZEABLE TAX BENEFITS ASSOCIATED WITH OWNING LOW-INCOME HOUSING. THESE TAX BENEFITS FLOWED FROM SEVERAL PROVISIONS OF THE TAX LAW BUT THE MOST IMPORTANT ENDUCEMENT WAS THE ABILITY TO DEPRECIATE A PROJECT MORE RAPIDLY THAN OTHER REAL ESTATE COULD BE DEPRECIATED, AND TO USE THE INCREASED DEPRECIATION TO REDUCE TAXES ON BOTH INCOME FROM THAT PROJECT AND INCOME FROM OTHER SOURCES.

THE POTENTIAL FOR LOSS

OUR ANALYSIS INDICATES THAT MOST OF CURRENTLY ASSISTED UNITS WILL CONTINUE TO HOUSE LOW AND MODERATE INCOME FAMILIES FOR THE TERM OF THEIR MORTGAGES OR SUBSIDY CONTRACTS, AND EVEN BEYOND. HOWEVER, OUR ANALYSIS ALSO INDICATES THAT SOME OF THESE UNITS WILL BE REMOVED FROM THE LOW INCOME HOUSING STOCK IF ADDITIONAL FINANCIAL INCENTIVES ARE NOT MADE AVAILABLE. WHILE WE BELIEVE SOME ANALYSTS HAVE GREATLY EXAGGERATED THE SIZE OF THE POTENTIAL LOSS, WE DO RECOGNIZE THAT LOSSES ARE POSSIBLE AND, IN SOME CASES, EVEN INEVITABLE.

I HAVE ALREADY GIVEN THE HOUSING SUBCOMMITTEE DATA ON OUR ESTIMATE OF THE SIZE OF THE PROBLEM AND I HAVE ATTACHED SOME OF THAT DATA TO THIS STATEMENT. TODAY, I WOULD LIKE TO DESCRIBE THE WAYS IN WHICH UNITS COULD BE REMOVED FROM THE LOW INCOME HOUSING STOCK. THERE ARE THREE WAYS SUCH LOSES COULD OCCUR.

FIRST, UNITS WILL BE LOST IF OWNERS EXERCISE THEIR CONTRACTUAL RIGHT TO PREPAY THEIR MORTGAGES AND CONVERT THEIR PROJECTS TO MORE PROFITABLE USES. OWNERS WILL PREPAY WHEN THE PROJECTS' HOUSING MARKETS AND PHYSICAL CONDITIONS WOULD PERMIT RENTS AND/OR SALES PRICES THAT WOULD PRODUCE A SUBSTANTIALLY HIGHER NET RETURN THAN OWNERS COULD DERIVE FROM OPERATING THE UNITS AS RENTALS FOR LOW AND MODERATE INCOME FAMILIES.

- WHILE THE 1987 HOUSING ACT SIGNIFICANTLY RESTRICTS OWNERS' ABILITY TO EXERCISE THEIR CONTRACTUAL RIGHT TO PREPAY AND WILL MAKE IT DIFFICULT FOR OWNERS TO PREPAY DURING THE NEXT 2 YEARS, THE ACT DOES NOT ELIMINATE THE POTENTIAL FOR PREPAYMENT. SOME OWNERS MAY BE ABLE TO MEET THE ACT'S PREREQUISITES FOR PREPAYMENT AND OTHER OWNERS WILL MERELY DELAY PREPAYMENT UNTIL THE '87 ACT'S RESTRICTIONS SUNSET IN FEBRUARY 1990.

- OUR STUDIES SHOW THAT, BY 1995 AT MOST 1,361 PROJECTS WITH 154,000 UNITS MAY CHOOSE TO PREPAY. THESE PROJECTS ACCOUNT FOR 25% OF T 236/BMIR PORTFOLIO AND 3.6% OF THE 4.2 MILLION UNITS OF HUD-ASSISTED RENTAL HOUSING NOW AVAILABLE.

  - WE ESTIMATE THAT ABOUT 739 OF THESE PROJECTS WOULD DECLINE ANY INCENTIVES CURRENTLY AVAILABLE AND WOULD DEFINITELY CONVERT THE PROJECT TO HIGHER INCOME USE.

  - ON THE BRIGHTER SIDE, WE BELIEVE AN APPROPRIATE MIX OF INCENTIVES COULD PERSUADE OWNERS OF THE REMAINING 622 PROJECTS TO CONTINUE TO HOUSE LOW AND MODERATE INCOME FAMILIES.

- O I BELIEVE IT IS IMPORTANT TO NOTE THAT A PREPAYMENT WILL NOT ALWAYS RESULT IN A LOW INCOME FAMILY LOSING SUBSIDY. SOME UNITS IN SOME PREPAYING PROJECTS WILL BE COVERED BY SECTION 8 CONTRACTS THAT WILL CONTINUE BEYOND THE PREPAYMENT. THE AFFORDABILITY OF OTHER UNITS CAN BE PRESERVED THROUGH VOUCHERS, AND HAVE BUDGETED TO GIVE VOUCHERS TO ALL ELIGIBLE FAMILIES ADVERSELY AFFECTED BY PREPAYMENTS.

THE SECOND WAY THE LOW AND MODERATE INCOME STOCK COULD BE REDUCED IS THROUGH PHYSICAL DETERIORATION. WHILE THE GREAT MAJORITY OF THIS STOCK IS WELL-MAINTAINED, A SMALL PERCENTAGE OF THESE UNITS NOW NEED REPAIRS AND REPLACEMENTS OF MAJOR COMPONENTS, AND THE PROJECTS' CASH FLOWS AND RESERVE ACCOUNTS ARE NOT ADEQUATE TO MEET THESE NEEDS. IN THE PAST, SOME OF THESE NEEDS WERE MET THROUGH OUR FLEXIBLE SUBSIDY PROGRAM, OWNER CONTRIBUTIONS AND RESYNDICATION PROCEEDS.

- O WHILE THE TAX REFORM ACT ESTABLISHES A LOW INCOME TAX CREDIT, IT ALSO REDUCED THE INCENTIVE FOR OWNERS TO CONTRIBUTE FUNDS AND THE MARKET FOR RESALE AND SYNDICATION OF THESE PROJECTS. THE ACT'S RESTRICTIONS ON USE OF PASSIVE LOSSES, ITS REQUIREMENT FOR 27.5 YEAR STRAIGHT-LINE DEPRECIATION, AND ITS ALTERNATIVE MINIMUM INCOME TAX ELIMINATE THE TAX ADVANTAGES PREVIOUSLY ASSOCIATED WITH OWNING LOW INCOME HOUSING.

- O WHILE WE WILL CONTINUE TO MAKE FLEXIBLE SUBSIDY AVAILABLE FOR REPAIRS AND FOR REPLACEMENT OF CAPITAL ITEMS, FLEXIBLE SUBSIDY FUNDS ARE LIMITED BY BUDGET CONSIDERATIONS.

THE THIRD WAY UNITS MAY BE LOST IS THROUGH TERMINATION OF SECTION 8 CONTRACTS. CONTRACTS TERMINATE EITHER BECAUSE THEIR 5, 15 OR 20 YEAR TERMS EXPIRE OR BECAUSE AN OWNER EXERCISES HIS/HER CONTRACTUAL RIGHT TO "OPT-OUT" AT THE END OF AN INCREMENTAL FIVE-YEAR TERM. THE BULK OF THESE CONTRACTS WILL TERMINATE IN THE MID-1990'S. SOME ANALYSTS BELIEVE THAT THESE CONTRACT TERMINATIONS WILL CREATE MASSIVE AFFORDABILITY PROBLEMS. THAT SIMPLY IS NOT THE CASE.

- O WHILE SOME STUDIES ASSUME THAT MANY OWNERS WILL OPT-OUT AT THE EARLIEST POSSIBLE DATE, RECENT EXPERIENCE INDICATES THAT WILL NOT HAPPEN. OVER THE PAST THREE FISCAL YEARS, OWNERS OPTED OUT OF ONLY ABOUT ONE PERCENT OF THE SECTION 8 UNITS THAT CAME UP FOR RENEWAL.

- 0 OF COURSE, WE WILL SEE SECTION 8 CONTRACTS EXPIRE OVER THE NEXT DECADE. HOWEVER, THESE EXPIRATIONS WILL NOT NECESSARILY CREATE AFFORDABILITY PROBLEMS FOR LOW INCOME TENANTS. THE PHYSICAL CONDITION AND LOCATION OF MANY OF THESE UNITS WILL DICTATE THAT THEY REMAIN AVAILABLE TO LOW INCOME USE. IT SIMPLY WOULD NOT BE FEASIBLE OR COST EFFECTIVE TO CONVERT SOME OF THESE UNITS TO HIGHER INCOME USES.

- 0 WE, HOWEVER, RECOGNIZE THAT SOME CONTRACT TERMINATIONS WILL CAUSE AFFORDABILITY PROBLEMS FOR LOW INCOME HOUSEHOLDS AND WE ARE PREPARED TO ADDRESS THESE PROBLEMS. THE DEPARTMENTAL BUDGET PROVIDES THAT ALL ELIGIBLE TENANTS AFFECTED BY EXPIRING SECTION 8 CONTRACTS WILL RECEIVE HOUSING VOUCHERS. IN THIS WAY, NEEDY FAMILIES WILL CONTINUE TO RECEIVE ASSISTANCE.

THE POTENTIAL LOSSES I HAVE DESCRIBED ABOVE ARE JUST THAT--LOSSES THAT COULD POTENTIALLY OCCUR IF ADDITIONAL TOOLS AND RESOURCES ARE NOT APPLIED. I AND MOST OTHERS BELIEVE THAT THESE POTENTIAL LOSSES COULD BE SIGNIFICANTLY REDUCED WITHOUT UNDULY BURDENING TENANTS AND WITHOUT ABBROGATING OWNERS' CONTRACTUAL RIGHTS IF:

1) THE FEDERAL GOVERNMENT, STATE AND LOCAL GOVERNMENTS AND INDUSTRY GROUPS WORK TOGETHER TO DEVELOP COST EFFECTIVE TOOLS AND INCENTIVES THAT CAN BE APPLIED FLEXIBLY ON A CASE-BY-CASE BASIS.

AND

2) THE COSTS OF THOSE TOOLS AND INCENTIVES ARE EQUITABLY DISTRIBUTED BETWEEN ALL LEVELS OF GOVERNMENT, PROJECT OWNERS AND TENANTS.

POSSIBLE WAYS TO REDUCE LOSS OF LOW INCOME UNITS

I WOULD NOW LIKE TO IDENTIFY SOME TOOLS THAT HUD AND/OR INDUSTRY REPRESENTATIVES BELIEVE COULD BE USED TO AVOID/MINIMIZE THE LOSSES ASSOCIATED WITH PREPAYMENTS. HOWEVER, BEFORE DOING SO, I WANT TO STRESS THAT I AM NOT PREPARED TO RECOMMEND ALL OF THESE TOOLS OR TO SUGGEST WHICH TOOLS SHOULD BE USED IN PARTICULAR INSTANCES. MUCH MORE ANALYSIS WILL BE NEEDED BEFORE WE CAN ENDORSE SOME OF THESE TOOLS. ALL OF US NEED TO CAREFULLY EXAMINE THE PROS AND CONS AND THE COSTS ASSOCIATED WITH EACH TOOL AND DECIDE WHAT IS THE MOST COST-EFFECTIVE WAY TO PROCEED.

First, owners who are likely to prepay could be provided with incentives to retain units as low and moderate income rentals. To be effective, the incentives need to provide returns comparable to returns the owners could obtain from converting the project to other uses. Industry representatives have suggested that we consider the tools I've listed below. Also, the Housing and Community Development Act of 1987 requires that we consider some of these tools.

O Releasing all/part of any residual receipts that have accumulated at the project. Residual receipts exist if the project has, in any year, generated cash in excess of amounts needed for expenses and allowable distributions. While many 236 and BMIR projects do not have residual receipts, the projects likely to prepay are the projects most likely to have sizeable residual receipts. Under current procedures, owners would receive these funds only when the 236/BMIR mortgage was paid off. Hence, early release of these funds could remove one incentive to prepay.

O Increasing the annual cash distributions the owner is allowed to pay from project income. Presently, BMIR and 236 owners may pay out only 6% of their original equity investment and that equity figure is calculated as the difference between the project's ORIGINAL mortgage and ORIGINAL replacement cost. It's been suggested that we recompute the equity base using the difference between the project's CURRENT appraised value and CURRENT mortgage balance. Doing so would significantly increase the distributions.

-- For example, the National Housing Preservation Task Force estimated that on one BMIR project where the appraised value has increased from $16,500 to $40,000/unit, the annual allowable distribution would increase from $99 to $1,680/unit. Of course, this increase would be feasible only if the project's cash flow can be increased to generate the additional distribution of $131/month.

-- While we are definitely open to using this incentive, we must first determine who will absorb the related costs. Will HUD absorb all/part of the cost by increasing existing subsidies? Can tenants' rents be increased? Could state and local governments augment the project's cash flow through tax abatement or other tools?

MOST ANALYSTS BELIEVE THAT THE INCENTIVES I HAVE JUST DESCRIBED WILL INDUCE SOME OWNERS TO RETAIN OWNERSHIP AND TO CONTINUE TO RENT TO LOW AND MODERATE INCOME FAMILIES. HOWEVER, WE ALL KNOW THE OTHER OWNERS WILL STILL ELECT TO SELL THEIR PROJECTS. FORTUNATELY, A SALE NEED NOT ALWAYS REMOVE UNITS FROM THE LOW-COST STOCK. WE COULD REDUCE THE UNIT LOSSES ASSOCIATED WITH THESE SALES BY:

1) INCREASING THE NUMBER OF ENTITIES WHO ARE WILLING TO BUY THESE PROPERTIES AND MAINTAIN THEIR LOW-INCOME USE.

AND

2) GIVING THE CURRENT OWNERS INCENTIVES TO SELL TO THESE ENTITIES. WHILE THESE INCENTIVES WOULD NEED TO PROVIDE RETURNS CLOSE TO THE RETURNS OWNERS COULD DERIVE FROM CONVERTING PROJECTS TO OTHER USES, OWNERS WOULD PROBABLY ACCEPT SOMEWHAT LOWER RETURNS BECAUSE THEY WOULD NOT NEED TO INCUR THE MARKETING AND IMPROVEMENT COSTS ASSOCIATED WITH CONVERTING THE PROJECT TO A MARKET-RATE USE.

PLEASE LET ME BRIEFLY IDENTIFY SOME OF THE TOOLS THAT HAVE BEEN SUGGESTED FOR CARRYING OUT THESE TWO TASKS.

O THE LOW-INCOME HOUSING TAX CREDIT. TAX CREDITS COULD BE A MAJOR TOOL FOR CARRYING OUT BOTH TASKS. BY ALLOCATING TAX CREDITS TO THESE PROJECTS, THE STATES COULD RESTORE SOME OF THE TAX ADVANTAGES THAT WERE ELIMINATED BY THE TAX REFORM ACT'S CHANGES IN DEPRECIATION AND PASSIVE LOSS RULES.

-- THE TAX CREDITS CAN ATTRACT PROFIT-MOTIVATED PURCHASERS WHO WOULD OTHERWISE NOT CONSIDER PURCHASING LOW INCOME HOUSING.

-- THE CREDITS CAN ALSO ENABLE MORE NON-PROFIT GROUPS TO BUY THESE PROJECTS. THE NON-PROFITS CAN FORM SYNDICATES TO USE THE CREDITS. INVOLVEMENT OF NON-PROFITS IS DESIRABLE AS NON-PROFIT GROUPS GENERALLY WOULD RETAIN THE LOW AND MODERATE INCOME USE OF THE PROJECT FOR EVEN LONGER THAN THE 15 YEARS REQUIRED BY THE TAX CREDIT RULES.

-- GIVEN THE POTENTIAL EFFECTIVENESS OF THE CREDIT, I AM VERY PLEASED TO SEE THAT SOME STATES -- INCLUDING YOUR HOME STATE, MR. CHAIRMAN -- PLAN TO DEVELOP THEIR OWN TAX CREDIT PROGRAMS. STATE CREDITS COULD OPERATE SEPARATELY FROM THE FEDERAL CREDIT OR COULD BE ADDED TO THE FEDERAL CREDIT, WHEN THE FEDERAL CREDIT WILL NOT PROVIDE A RETURN SUFFICIENT TO PRESERVE UNITS.

O PERMITTING OWNERS TO PLACE SECOND MORTGAGES ON PROPERTIES LIKELY TO PREPAY AND TO USE THE LOAN PROCEEDS TO TAKE OUT ALL/PART OF THEIR EQUITY, WITH EQUITY COMPUTED USING THE PROJECT'S CURRENT APPRAISED VALUE. WHILE I HAVE PREVIOUSLY TESTIFIED THAT WE WILL SERIOUSLY CONSIDER THIS TOOL AND THE 1987 HOUSING ACT PROVIDES FOR SUCH LOANS, BEFORE APPLYING THIS TOOL WE MUST OVERCOME THE OBSTACLES ASSOCIATED WITH IT. FOR EXAMPLE:

-- HOW WILL PROJECTS PAY THE ADDITIONAL DEBT SERVICE ASSOCIATED WITH THESE LOANS? CAN RENTS BE INCREASED AND STILL BE AFFORDABLE TO LOW AND MODERATE INCOME TENANTS?

-- WILL HOLDERS OF THESE PROJECTS' MORTGAGES ACCEPT SECONDARY FINANCING THAT IS SECURED BY THE PROJECT? WHILE THE '87 HOUSING ACT PROVIDES THAT MORTGAGEES MAY NOT WITHHOLD APPROVAL DURING THE NEXT 2 YEARS, WHAT HAPPENS BEYOND 1990?

O INCREASING RENTS OF BMIR AND 236 TENANTS THAT NOW PAY LESS THAN 30% OF THEIR INCOME FOR RENT. UNDER CURRENT LAWS AND PROCEDURES, THESE PROJECTS' HIGHEST INCOME TENANTS MAY PAY NO MORE THAN THE HUD-APPROVED "MARKET" RENT. THIS RENT IS ALMOST ALWAYS LESS THAN 30% OF THE FAMILY'S INCOME AND CAN BE AS LOW AS 15% OF A FAMILY'S INCOME.

-- WHILE ANY 236 OR BMIR PROJECT MAY HAVE TENANTS PAYING THESE LOW PERCENTAGES OF INCOME, PROJECTS LIKELY TO PREPAY PROBABLY WILL HAVE THE HIGHEST PERCENTAGES OF THESE TENANTS.

-- IF THESE TENANTS' RENTS WERE INCREASED TO 30% OF THEIR INCOMES, ALL TENANTS WOULD PAY THE SAME PERCENTAGES OF INCOME AND THE ADDITIONAL INCOME COULD BE USED TO OFFSET THE COSTS OF THE EQUITY TAKE-OUT AND INCREASED DISTRIBUTIONS I JUST DESCRIBED.

O ALLOWING OWNERS TO CONVERT PART OF A PROJECT TO MARKET RATE USE WHILE RETAINING SOME OF THE UNITS FOR LOW AND MODERATE INCOME RENTALS. WHILE SOME UNITS WOULD BE LOST, LO~~O~~SING SOME UNITS IS BETTER THAN LOOSING ALL OF THE PROJECT'S UNITS.

- 0 State agency, foundation or corporate grants to assist non-profits in purchasing these projects. These grants would assist in closing the gap between the sales prices/rents owners could get if they converted the project to market-rate uses and the prices purchasers buying subject to use restrictions would pay. Some states are already assisting non-profits to make such purchases, and organizations such as the Local Initiatives Support Corporation have obtained grants, loans and contributions from corporations and foundations.

Since your staff indicated that you were primarily interested in addressing inventory losses associated with prepayments, I have focused my comments on ways of reducing those losses. I, however, think it's important to note that under present law many of the tools I have discussed could also be used to address losses due to physical deterioration. For example:

- 0 Tax credit allocations and an increased ability to use those credits could generate significant private capital for repairs and capital replacements.

- 0 Requiring higher income tenants to pay at least 30% of their income for rent would provide funds to cover operating losses, secondary debt service and repairs -- without unduly burdening the tenants.

We, of course, will continue to offer Flexible Subsidy and Section 8 assistance that is authorized and available. We expect that these tools will be used in combination with the innovative tools states and local governments are now developing.

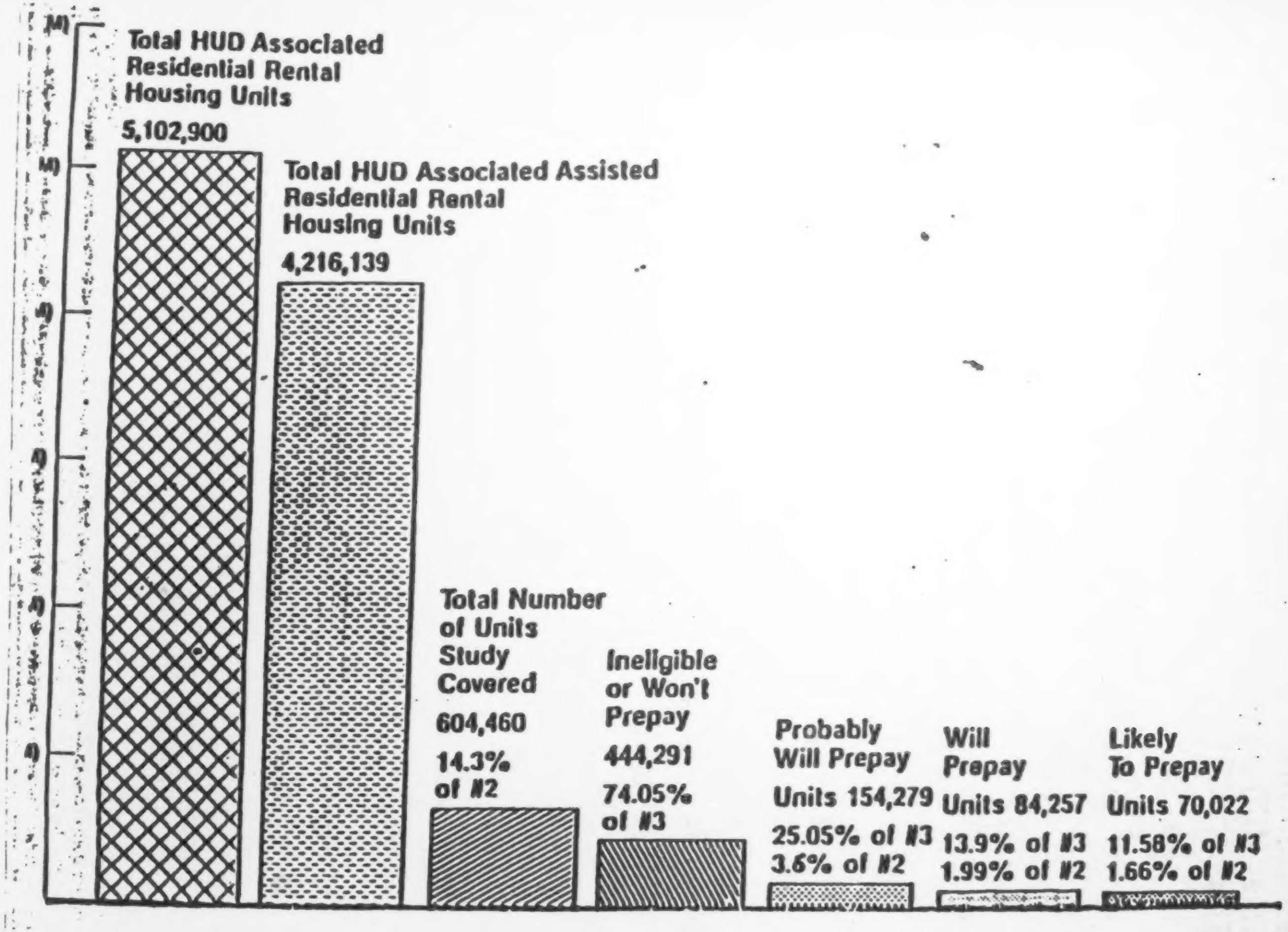
As you can see, Mr. Chairman, a lot of work lies ahead. While possible incentives and tools have been identified, we now must make some tough decisions--i.e., which tools are most effective? Under what circumstances should each tool be used? What price will we pay to preserve these units? And how will that cost be distributed between the federal government, state and local government, tenants and owner? A lot of hard work lies ahead for all of us.

WITH RESPECT TO HR 3663, THE COMMITTEE WAS GIVEN THE ADMINISTRATION'S POSITION BY DEPUTY ASSISTANT SECRETARY OF THE TREASURY C. EUGENE STEUERLE ON MARCH 2, 1988. MY OWN VIEW ON THE LONG TERM UTILITY OF THE LOW INCOME HOUSING TAX CREDIT IS THAT THE MARKET PLACE WILL TELL US HOW WELL IT CAN WORK. WE KNOW THAT THE FIRST YEAR WAS RATHER SLOW, BUT THIS IS TRUE OF ALL NEW TAX MEASURES. WE WILL CONTINUE TO MONITOR ITS USE DURING 1988. HOPEFULLY, BY EARLY 1989 WE WILL BE IN A BETTER POSITION TO MAKE SOUND JUDGMENTS ON WHETHER ANY IMPROVEMENTS MAY BE NEEDED. BY THAT TIME, WE WILL HAVE THE EXPERIENCE OF THOSE WHO ARE USING THE CREDIT TO GUIDE US.

MR. CHAIRMAN, THIS CONCLUDES MY COMMENTS. THANK YOU FOR THE OPPORTUNITY TO DISCUSS THESE IMPORTANT HOUSING ISSUES. THE DEPARTMENT STANDS READY TO WORK WITH CONGRESS AND THE INDUSTRY TASK FORCES NOW STUDYING THESE PRESERVATION PROBLEMS.

Breakdown of Graph Entitled Total HUD Associated Residential Assisted Housing Units Through 2/87

1. Insured and HUD Held Section 236, 221(d)(3) BMIR 221(d)(3) MR R/S LMSA Projects	604,460
2. State Financed Section 236 Projects	117,627
3. Section 221(d)(4) Section 8 Insured and HUD Held	298,214
4. Non/Insured Section 8 Project Based	437,860
5. Section 202	204,828
6. Conventional Public Housing	1,227,057
7. Mod Rehab Section 8	364,198
8. Certificates	876,532
9. Vouchers	85,363
Total	4,216,139



Total HUD Associated
Residential Rental
Housing Units
5,102,900
Total HUD Associated Assisted
Residential Rental
Housing Units
4,216,139
Total Number
of Units
Study
Covered
604,460
14.3%
of #2
Ineligible
or Won't
Prepay
444,291
74.05%
of #3
Probably
Will Prepay
Units 154,279
25.05% of #3
3.6% of #2
Will
Prepay
Units 84,257
13.9% of #3
1.99% of #2
Likely
To Prepay
Units 70,022
11.58% of #3
1.66% of #2

Probable Prepays

- Likely Will Prepay — 70,022 Units
- Will Prepay — 84,257 Units

Total 154,279

- 25.05% of Study Units
- 3.5% of Total HUD Assisted Units

Chairman RANGEL. Thank you so much. Let's hear from the General Accounting Office, John Luke, Associate Director of Resources Community and Economic Development. And he has with him Dennis Fricke, and Mr. Sgobba, Evaluator and Group Director.

STATEMENT OF JOHN H. LUKE, ASSOCIATE DIRECTOR, RESOURCES COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY DENNIS FRICKE, GROUP DIRECTOR, AND VICTOR SGOBBA, EVALUATOR

Mr. LUKE. Thank you, Mr. Chairman. As you indicated, I have with me Mr. Dennis Fricke, our group director, who heads up all of our audit work on HUD's multifamily subsidized housing programs, and Mr. Vic Sgobba, to his right, who assists him in many of those audit activities.

We, too, appreciate the opportunity to assist your Subcommittee in considering how the Federal Government might better respond to the potential loss of a significant number of privately owned and federally subsidized low-income rental housing units. The potential loss of low-income housing is a subject which we have previously reported on, and one which we consider to be critical in designing future Federal housing policy.

In the last two decades, approximately 2 million low-income housing units have been constructed through assistance provided by various Federal programs.

These programs include the Department of Housing and Urban Development section 8, new construction program, section 221(d)(3) program, section 236 program, and the Farmers Home Administration, section 515, rural rental housing program. Over the next decade, many of the federally subsidized units are at risk of being lost from the low-income stock because of the expiration restrictions requiring that projects serve low-income persons.

My remarks today provide an overview of our findings from two reports we issued regarding the potential loss of federally assisted rental housing units, and provide some observations on H.R. 3663, that the subcommittee may wish to consider concerning the use of tax policy as a means of encouraging the preservation of low-income housing units.

OVERVIEW OF POTENTIAL REDUCTION IN THE PRIVATELY OWNED AND FEDERALLY ASSISTED INVENTORY

On June 16, 1986, we issued a report on the 1985 inventory of privately owned and federally assisted rental housing administered by HUD and Farmers Home Administration, and the potential impact of expiring Section 8 contracts and mortgage prepayment restrictions on this inventory.[1] Just recently, we issued another report dated February 11, 1988, which provides an update on the potential loss of low-income rental housing units from the section 515 rural rental housing program administered by the Farmers

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[1] Rental Housing: Potential Reduction in the Privately Owned and Federally Assisted Inventory (GAO/RCED-86-176FS).

Home Administration.[1] Collectively, the two reports show that almost half of the approximately 2-million unit inventory is vulnerable to loss by the end of fiscal year 1995 through owners' voluntary withdrawal from Federal housing programs.

Since our first study, other public and private groups have conducted more indepth evaluations. As a result, the Congress has found that in the next decade, more than 465,000 low-income housing units produced with assistance under section 8 of the U.S. Housing Act of 1937 could be lost as a result of the expiration of the rental assistance contracts.

In the next 15 years, more than 330,000 low-income housing units insured or assisted under sections 221(d)(3) and 236 of the National Housing Act could be lost as a result of the termination of low-income affordability restrictions.

And some 150,000 units of rural low-income housing financed under section 515 of the Housing Act of 1949 are threatened with loss as a result of the prepayment of mortgages by owners.

GAO'S OBSERVATIONS ON RECENT PRESERVATION INITIATIVES

During the 1980's, the reduction and elimination of direct and indirect Federal assistance gave private owners incentives to withdraw from Federal housing programs, and has created an environment for future losses. Recognizing this problem, the Congress is pursuing a dual approach to preserve low-income housing. The Housing and Community Development Act of 1987 provides interim measures aimed at minimizing losses from the federally assisted inventory. Specifically, they include incentives designed to increase owners' rates of return, restraints on prepayment of mortgages by owners, and provisions supporting the purchase of projects by nonprofit or public agencies. In addition, H.R. 3663 not only proposes to strengthen the tax incentives that cover these Federal housing programs, but would also extend benefits to State and local housing programs as well.

Mr. Chairman, the following question comes to mind immediately: What amount of incentives is necessary to retain private investment in low-income housing, but prevent private investors in low-income housing from taking advantage of opportunities for extra cash and returns? Unfortunately, differences in market areas preclude a simple answer.

The current inventory of privately owned, Federally assisted housing has been characterized as representing three different market areas. Generally, projects located in strong market areas have a high potential to be lost from the inventory. The economies of these housing markets offer owners the possibility of profitable returns through market-rate rentals, or conversion to condominiums, or some alternative use such as office space. Therefore, a very deep subsidy may be required to induce their continued participation.

At the other end of the spectrum are units that have no better economic use or potential than as low-income housing. The markets in which they are located will not support higher rents or alternative uses for the property. The lack of these units' marketability will discourage owners from disposing of them in the private sector. Consequently, little or no incentive, tax or otherwise, may be required to induce their continued participation.

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[1] Rural Rental Housing: Impact of Section 515 Loan Prepayments on Tenants and Housing Availability (GAO/RCED-88-15BR).

Other units probably have a borderline position in the market and have the potential to move either way. They may be located in markets which are stable but not showing signs of increased rent or gentrification. The owners can only realize a limited gain by converting to market rentals or other uses. The incentives needed to induce these owners to retain their projects as low-income housing would fall somewhere between the other two extremes.

The incentives provided in the Housing and Community Development Act of 1987 are aimed at increasing owners' rates of return. They include greater cash distribution allowances, reduced loan interest rates, increased rents under section 8 contracts, and provisions for insuring second mortgage equity loans, and financing capital improvements.

H.R. 3663, like the Housing and Community Development Act is designed to increase investor returns. The major provisions include allowing property owners additional depreciation deductions by restoring the depreciable basis of their property, if they maintain their inventory as low-income housing for at least 20 additional years; excluding from taxation the noncash gain on the sale of a building to a subsequent owner who agrees to maintain the property as low-income or moderate-income housing for 15 years; and allowing greater opportunities for use of the low-income housing tax credit.

Both legislative initiatives should facilitate the retention of low-income housing units. We believe, however, that H.R. 3663 could be more effective in achieving this objection if the subcommittee considered such options as:

Strengthening certain targeting provisions to ensure that housing projects provide the maximum possible assistance to low- and-moderate income households; enhancing cost-control provisions aimed at maximizing the number of units assisted while minimizing costs; and strengthening accountability and oversight by requiring a program evaluation mechanism.

I will discuss each of these areas along with our rationale for the needed changes.

MAXIMIZING ASSISTANCE TO LOW-INCOME HOUSEHOLDS

While the Housing and Community Development Act and H.R. 3663 express the same objection of preventing the loss of low-income housing, there are substantial differences in the two initiatives. Specifically, the housing act limits its incentives to specific HUD and Farmers Home Administration housing programs which have very similar definitions of low-income households. Generally these programs give a greater priority to assisting very low-income households, those with incomes not greater than 50 percent of the area medium income, who often have the most critical housing needs. Conversely, H.R. 3663 covers a broad base of Federal, State, and local housing programs whose definitions of low income may differ from HUD and Farmers Home Administration program definitions.

H.R. 3663 offers tax incentives to owners of qualified low-income housing which, as defined in the bill, is housing "which is substantially assisted, financed, or operated under a Federal, State, or local housing program, and subject to restrictions on rent or income with respect to at least 20 percent of the tenants." Any differences in the low-income definitions among the Federal, State and local housing programs would not ensure that the tax incentives offered will be directed toward the most critical housing needs. This would not conform with current national housing policies which define low income in the context of those most in need. We raised this issue in a previous report on tax-exempt bond financing,[1] where we found that above-average income renters could qualify as low- and moderate-income renters because program income ceilings were set at 80 percent of the areas' median income and did not include adjustments for family size until after 1985. The Congress reaffirmed its commitment to helping the most needy in the Tax Reform Act of 1986, when it defined low income for purposes of obtaining low-income housing tax credit as households with incomes not exceeding 50 or 60 percent of the area median income and included household size adjustments.

H.R. 3663 also extends its tax benefits to projects which partially serve low-income families. Specifically, the bill allows projects to receive the full tax benefits, even though as few as 20 percent of the units serve low-income families. We have expressed concern in the past as to whether tax subsidies are most efficiently directed when as many as 80 percent of a project's units may not be serving low-income households. Accordingly, we would favor a higher low-income occupancy requirement than presently contained in H.R. 3663.

ENHANCING COST-CONTROL PROVISIONS

Cost controls are necessary for any program if it is to successfully encourage the minimization of costs and the optimization of benefits. We have repeatedly advocated strengthened controls for direct subsidy programs such as Section 8 and we strongly believe that cost controls should be a major emphasis in any tax reform proposal. In this regard, an excellent feature of H.R. 3663 is that it requires recapture of additional depreciation if the owner does not hold the property as low-income housing for 20 years as prescribed in the bill.

The more specific targeting of H.R. 3663, as I previously mentioned, would further control costs by limiting the tax incentives to those projects serving the most needy. For example, the 1987 Housing Act does this by requiring HUD and the Farmers Home Administration to determine, on the basis of market conditions, that owners need an incentive to retain their projects in the low-income housing stock; the incentive provides the owners with a fair return on their investments; and the incentive is the least costly alternative for the Federal Government to pursue.

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[1] Rental Housing: Costs and Benefits of Financing with Tax-Exempt Bonds (GAO/RCED-86-2).

As a complement to this targeting, the Subcommittee may wish to consider, for federally assisted projects, linking the tax incentives to the incentives provided for in the Housing and Community Development Act of 1987, and limiting their use to only those situations where HUD or Farmers Home Administration would determine they are necessary to retain a particular project in the low-income rental stock. Likewise, we believe that for State and local housing programs, tax incentives should only be provided when either HUD or Farmers Home Administration determines that they are necessary and/or appropriate to retain a project in the low-income stock. I recognize, Mr. Chairman, that this is a substantial departure from the present bill, but we believe it is an option worth exploring. This check goes to the heart of an earlier issue that I raised, namely, the need to ensure project owners are provided with a fair return on investment without providing windfall profits.

STRENGTHENING ACCOUNTABILITY AND OVERSIGHT

Finally, H.R. 3663 does not specifically provide a mechanism for evaluating the degree to which the incentives enumerated in the bill are effective and efficient in preserving the stock. Program evaluation is one of the key tools in assuring the effective allocation of scarce resources and should be an integral component of any housing preservation initiative. Again, one means to achieve this oversight would be to tie the tax incentives to the preservation provisions of the Housing and Community Development Act. In this regard, since HUD and Farmers Home Administration are required at the outset to determine a project owner's need for incentives and the appropriate incentives to provide, it is logical that they also be required to report to the Congress on a periodic basis which incentives have been used, their cost, and their degree of effectiveness in retaining low-income housing units.

Mr. Chairman, that concludes my prepared statement and I would be pleased to respond to any questions that you or members of the Subcommittee may have.

Chairman RANGEL. Thank you, Mr. Luke. Certainly as it relates to accountability and oversight, I hope staff would take that into consideration in the final draft of the bill.

What would you consider, Mr. Luke, to be low income as relates to the targeting that you are recommending? What incomes are you talking about?

Mr. LUKE. Well, if you look at the section 8 program of HUD as well as some other HUD programs they define very low income to be those at 50 percent or below area median income; low income to be 80 percent or below; and moderate income to be above the 80 percent level. So those are fairly well published and used with respect to the housing programs.

Chairman RANGEL. When you find that the only reason you were able to get 20 percent of the low income into the development in the first place was because you were able to have the 80 percent to level out the rent roll, what would you suggest? Is there any way to target the 20 percent without looking at the overall development in the project to avoid the transfer for other purposes?

I mean is there any way to target to the 20 percent and ignore the 80?

Mr. **LUKE**. There are ways to target, but there are costs associated with targeting. The issue that I raise in terms of the current bill is, as I see it now, there are no limits in terms of who can participate.

Chairman **RANGEL**. As relates to the 80 percent, you mean?

Mr. **LUKE**. Yes.

Chairman **RANGEL**. Well, I agree with you. I need some tools to work with.

Suppose HUD—will you comment on the testimony of Mr. Luke as it relates to H.R. 3663? I want you to know that I agree with what he said in terms of the bill being broad enough to go beyond low income. But would you comment on it from the Administration's point of view.

Mr. **DEMERY**. I think while I was not here yesterday to hear the testimony——

Chairman **RANGEL**. Forget Treasury. They are all right. We can handle that. We just cannot handle HUD.

Mr. **DEMERY**. I missed the first part of your question.

Chairman **RANGEL**. Don't you worry about Treasury. I am talking about housing, not tax policy.

Mr. **DEMERY**. The objective in these hearings, and I think the intent of the Housing and Community Development Act of 1987, was to focus scarce housing resources on the preservation of low-income housing. I would agree that the definition of low and very low-income housing or very low income qualified tenants is fairly well established and fairly well defined. I have not seen this testimony before and have not been able to really focus on this concept of targeting.

Chairman **RANGEL**. Well, suppose you adopt it in concept. If we were able to find the mechanism to target it to use language that is in existing law, which has already been accepted by HUD, would you be able to support H.R. 3663 as a sound housing policy measure?

Mr. **DEMERY**. I think that we would be able to implement those provisions easily.

Chairman **RANGEL**. So you would say that there is a way for the——

Mr. **DEMERY**. It is basically consistent with what our operation is right now.

Chairman **RANGEL**. And consistent with trying to maintain the existing housing stock for low-income people?

In other words, where it is abundantly clear that under existing law, many owners would be transferring the property because the restrictions will no longer be in place. And we are trying through H.R. 3663 to provide incentives to give viable options to the owners not to do that. And I am trying to ask HUD that even though in its present form you may have problems with the options that we are giving the owners, do you believe that it makes some good housing policy sense to try to provide further initiatives to existing law to maintain the inventory of privately owned——

Mr. **Demery**. As I said in my remarks, and as I submitted in my written testimony, any tool that we have at our disposal to deal with this issue is good public policy.

Chairman **Rangel**. Then have you worked with Congressman Frank, with the tax-writing committee staff in trying to get the type of tax incentive that would enhance your overall housing policy?

Mr. **Demery**. The way the HUD is organized, that particular aspect would not fall within my jurisdiction. So the answer is no.

Chairman **Rangel**. Well, let me tell you, my problem is that if Housing refers me to the Treasury, how do I find what the administration position would be on sound housing policy? In other words, if we on the committee are trying to provide you with tools that would enhance your overall objective to provide the maximum amount of housing to the low-income people, especially those that have been previously subsidized, and now those restrictions are being removed, where the owner can really enhance his financial position at the expense of low and moderate income, I assume it is your goal to maintain that stock. And if the tax writing committee says right on, we support you, and we have got some tools that would enhance your overall policy, where in HUD should we go to offer bills similar to H.R. 3663 so that you can put this in your housing policy package?

Mr. **Demery**. In dealing with the range of options and the range of tools that would speak to the subject of prepayment and preservation, I did work with Congressman Frank and the Housing Subcommittee to help develop some of the tools that were included in the legislation.

Chairman **Rangel**. That's part one.

Mr. **Demery**. The tax component of that has been delegated by the Secretary to the Office of Policy Development and Research, Duncan MacRae, who I believe appeared before your committee yesterday. So the answer to your question would be Duncan MacRae.

Chairman **Rangel**. I thought I missed something because Mr. MacRae really did not deal with H.R. 3663.

Suppose I would ask you to go back to Mr. MacRae. The same building, right?

Mr. **Demery**. Yes.

Chairman **Rangel**. Good. And to ask him not to give us any advice on sound tax policy, but to work with you in seeing whether or not the housing policies that you have been able to establish with the Housing Subcommittee could be enhanced in preserving the stock, taking into consideration the comments made by Mr. Luke, those parts that you agree with, to see whether or not we can get HUD to support a package that would include other tools for you to reach a sound housing policy objective.

Does it make any sense at all?

Mr. **Demery**. I believe any time you can divide the burden of coming up with a solution to a complicated problem, the likelihood of a solution increases. So I would be happy to work with Duncan, as we have in the past on specific issues. I will take back that message back to him.

Chairman **Rangel**. Well, I look forward to hearing from you in an informal way. We can get together with staff. We can call some meetings and see what we can work out.

Mr. Luke, it is a fine document. You raised all of the problems that I met when we first started to draft the document. We know that you have to throw a lot of money or incentives or suffer revenue shortfalls in trying to manipulate the conduct of people who have options out there to make money that you cannot get in just providing housing for the poor. Where that line is is a marketplace decision.

On the other hand, I just do not see how you can target to deal with the 20 percent of low income that is in a particular development and exclude those people that live in the same development that is owned by one developer, even though those people have a higher income. And, of course, when you come from a metropolitan area such as I do, what is considered moderate income for us is really extremely high income for other parts of the country.

So the General Accounting Office has always done tremendous work and, as always, improves when they agree with me. This is one of your better documents.

Mr. **Luke**. Beg your pardon, sir?

Chairman **Rangel**. I said this is a good document, except I need some more help on how to reach the objectives that we want to.

Mr. **Luke**. Okay. Let me try again in terms of what we really mean on the targeting side.

Right now the bill calls for setting aside 20 percent for low income. It is that 20 percent that I am talking about that we have no idea where the bill comes out in terms of at which level you want to provide assistance; whether that is at the 50 percent level, whether it is at the 80 percent level, whether it is the 100 percent level.

In addition to the Housing Act stipulating some kind of definition in terms of low income, as I indicated earlier, the 1986 Tax Act also has some guidance. It promulgated what it called, the 20-50 rule and the 40-60 rule. Under the 20--50, 20 percent of the units must be restricted for low income below the 50 percent area median, if the area median went up to 60 percent, at least 40 percent of those units must be set aside for low income. What I am suggesting is it would be helpful if the bill were to stipulate some level at which it is targeting those assistance.

Chairman **Rangel**. Well, I want to thank you, and I look forward to continuing this discussion.

Mr. Coyne?

Mr. **Coyne**. Thank you. No questions.

Chairman **Rangel**. Well, thank you very much. A very well thought out document. We really appreciate it. Mr. Demery, I look forward to working with you.

Mr. **Demery**. Thank you.

Chairman **Rangel**. Our next panel is Marvin Siflinger, executive director of the Massachusetts Housing Finance Agency, and Bill Eimicke from the great State of New York, New York State Division of Housing and Community Development.

Mr. **Coyne** [presiding]. You can proceed, Mr. Siflinger.

STATEMENT OF MARVIN SIFLINGER, TREASURER, NATIONAL COUNCIL OF STATE HOUSING AGENCIES, AND EXECUTIVE DIRECTOR, MASSACHUSETTS HOUSING FINANCE AGENCY

Mr. **Siflinger**. Thank you, Mr. Chairman.

My name is Marvin Siflinger. I am the executive director of the Massachusetts Housing Finance Agency and the treasurer of the National Council of State Housing Agencies. Our organization, NCSHA, represents the housing finance agencies of all States as well as the District of Columbia, the Virgin Islands and Puerto Rico.

It is an honor to appear before this subcommittee, and the members of this committee are long-standing and respected friends of low-income housing.

As you know, the current year is an important one for State housing finance agencies which financed approximately half of the 2 million units of federally assisted, privately owned housing. We are troubled by the trend now emerging that portends the almost total loss of this inventory in a little over a decade.

In Massachusetts alone, we have identified 30,000 units of low and moderate income housing where owners will be eligible to prepay their mortgages between now and 1997. Approximately 11,000 of these units are in the Massachusetts Housing Finance Agency portfolio.

We are faced with two very basic and conflicting principles: the rights of the owners to exercise their prepayment options and the rights of low and moderate income residents to affordable, decent housing.

In Massachusetts, we have aggressively committed State resources to rental housing production to attempt to fill the gap created by the termination of the Federal production programs. Recently, in response to our concerns related to the issue of expiring use, the Massachusetts Housing Finance Agency board of directors approved a policy to require that low income units in our soon-to-be-completed and future rental developments remain as such in perpetuity.

However, it is clear that the States alone cannot solve this problem and that Federal resources are essential.

Both Carl Riedy, executive vice president of the National Council of State Housing Agencies, and I were members of the National Housing Preservation Task Force, which recently made recommendations to Senators Cranston and D'Amato. I would like to highlight some of the financial and tax recommendations.

The financial recommendations include an increase in allowable distribution, recovery of accumulated equity, and low interest loans for capital improvements. The tax incentives include reestablishment of depreciable tax bases, low income housing tax credits for existing owners, nontaxable sale to public and nonprofit entities. These tax recommendations are consistent with H.R. 3663.

It is also important that we recognize that expiring rent subsidies are a major threat to the existing housing inventory, and the task force recommends actions in this regard.

In 1988, the combined ramifications of the reductions in direct spending for housing and the Tax Reform Act of 1986 are that low income housing production in almost every State is at a standstill. As we discussed in detail yesterday, the credit program needs improvement; tax exempt bonds for housing have been rendered inoperative without additional State and Federal subsidies; and depreciation schedules have been lengthened beyond value.

H.R. 3663 is significant in that it provides the necessary tax relief in addition to the incentives identified in the 1987 Housing Act to permit States to develop workout plans for projects in danger of prepayment.

A review of the MHFA portfolio indicates that 20 of our 56 expiring use developments, representing, 3,200 units, have these kinds of physical and financial needs and could benefit from this legislation.

I see my time is up, Mr. Chairman. I have submitted written testimony that more completely outlines our comments and recommendations. I would be happy to answer any questions that you may have.

Mr. COYNE. Thank you.

[The statement of Mr. Siflinger follows:]

Testimony of Marvin Siflinger
Executive Director, Massachusetts Housing Finance Agency
Treasurer of the National Council of State Housing Agencies
Before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means Committee
U.S. House of Representative

Thank you Mr. Chairman. I would like to join the previous witnesses in congratulating you for holding this important set of hearings. My name is Marvin Siflinger, I am the Executive Director of the Massachusetts Housing Finance Agency and the Treasurer of our trade association, The National Council of State Housing Agencies (NCSHA). NCSHA represents the housing finance agencies of all states as well as the District of Columbia, the Virgin Islands, and Puerto Rico. My involvement with NCSHA, combined with my experience in Massachussetts and my service on the National Housing Preservation Task Force afford me a unique perspective on the issue of preserving America's low income stock.

It is an honor to appear before you and this subcommittee Mr. Chairman. You are a long-standing and respected friend of low-and moderate-income housing and your leadership is most appreciated. Especially laudable is the fact that you are holding hearings on an essential housing issue in a Ways and Means subcommittee, and that you have jointly introduced a bill, H.R. 3663 with Congressman Frank of the House Banking Committee to address a special low-income housing concern. From the perspective of state housing finance agencies, this cooperation between important members of the two committees whose deliberations are so vital to housing is essential.

As you know, the current year is an important one for state housing finance agencies. My colleague Terry Duvernay presented our views to you on the Low-Income Housing Tax Credit yesterday. We also have followed closely the activities of the Cranston/D'Amato housing policy study. Finally, we are focussing enormous amount of energy on passage of H.R. 2640, the Mortgage Revenue Bond Sunset extension. We appreciate your being an original cosponsor. In the latter case, our capacity to address the fullest scope of housing needs and effectively join the efforts we are deliberating on today is at stake. For those of us at the state level, the actions Congress takes this year will shape in large measure the state-federal partnership as we seek to re-energize the nation's housing policies.

Preservation of the assisted housing inventory is especially important to my state where the problem has urgency, but it is also of great importance to state housing finance agencies generally. State housing finance agencies financed approximately half of the 2 million units of federally assisted privately owned housing. We are troubled by the trend now emerging that portends the almost total loss of this inventory in little over a decade. Loss of such magnitude would be especially senseless, since preservation is a less costly alternative than replacement of the housing stock.

Magnitude of the Problem in Massachusetts

In Massachusetts alone, we have identified 30,000 units of low and moderate income housing where owners will be eligible to prepay their mortgages between now and 1997. Approximately 11,000 of these units are in the Massachusetts Housing Finance Authority (MHFA) portfolio. With prepayment, all restrictions relative to the continuation of the units for low- and moderate-income rental expire.

The expectation twenty years ago, when the prepayment provisions were written into the HUD contracts with the owners, was that the federal government would continue to produce replacement housing for low -and moderate-income persons. Now we are at, or approaching, that twenty-year point and the federal government has virtually withdrawn from housing production.

We are faced with two very basic and conflicting principles . . . the rights of the owners to exercise their prepayment options and the rights of low- and moderate-income residents to affordable, decent housing.

In Massachusetts, we have aggressively committed state resources to rental housing production to attempt to fill the gap created by the termination of federal production programs. During the past four years, the MHFA has financed 8,518 units of rental housing (includes Round IV proposals) under the State Housing Assistance for Rental Production (SHARP) program using $25 million in state subsidies from Governor's Dukakis' Massachusetts Housing Partnership and $644 million in MHFA loan commitments. Initially, the housing had fifteen year use and occupancy restrictions. Recently, in response to our concerns related to the issue of expiring use, the MHFA Board approved a policy to require that the low and moderate-income units in SHARP assisted developments remain as such in perpetuity.

In late 1987, Governor Dukakis introduced a property-owners' pledge agreement, which has since been signed by a majority of owners potentially eligible to prepay their mortgages within the next five years. The pledge essentially is the same as the Alternative State Strategy identified in Title II of the Housing Act of 1987. The Massachusetts pledge commits both owners and the commonwealth to work together to identify the steps to be taken to achieve mutual goals of protecting current residents and preserving housing resources to the maximum extent possible while recognizing reasonable financial expectations on the part of owners.

The Massachusetts pledge clearly identifies the federal government as a major player in this effort to preserve housing resources. The pledge agreement states that the properties were constructed under federal programs, supported with federal subsidies, and the contracts were executed between the federal government and the owners.

It is clear that the states alone cannot solve this problem and that federal resources are essential.

An Emerging Concensus on Preservation

Both Carl Riedy, Executive Vice President of the National Council of State Housing Agencies and I were members of the National Housing Preservation Task Force. This Task Force comprised twenty-seven members with experience that covered a broad spectrum of interests in rental housing. Through our representation, the interests of states were articulated and included in the final report. The Task Force unanimously concurred that, while states should have a strong role in all issues of preservation of existing low- and moderate-income stock in their states, the goal of preservation will not be accomplished without the Federal Government taking the lead role of convenor of the partnership - reviewer of plans and the first source of incentives. I will briefly review the major findings and recommendations of the Task Force.

The Task Force found that the possibility exists that by 1995 reduction in units through prepayments and other means could approach 1,200,000 units. By 2000, reduction could exceed 1,800,000 units. These units represent virtually the entire low-income housing stock.

Major Findings of the Task Force

The threat to the inventory is found in three principal areas:

1. Mortgage Prepayments

HUD reports that in June 1987 there were 360,528 units in 3,215 federally assisted projects that had the ability to prepay after 20 years

At the end of 1995, 316,481 of these units in 2,875 projects will have reached the 20 year point

2. Expiring Subsidies

Both project based and tenant based subsidies are slated to expire. By far the greatest threat to the inventory arises in the following areas.

- Tenant based Section 8 subsidies
  By 1995 - 636,000 units will expire
- Loan Management Set-Asides (LMSA)
  By 2000 - practically all of the 280,000 units will have lost their Section 8 support
- Section 8 NC/SR
  By 2000 - 200,000 units will be off subsidy
  By 1994 - 180,000 could be lost if owners elect to terminate
- Moderate Rehab
  By 2000 - over 90,000 Section 8 will expire

By 1995, over 700,000 Section 8 units will lose their subsidy. Should owners decide to opt out, almost 1,000,000 units could be lost.

3. Physical Condition

Aging physical plants and absence of adequate cash flow are an on-going problem. Resyndications alleviated this somewhat during 1981-84, but this flurry of activity has not been enough in the face of project aging and resulting deterioration.

Currently, 300,000 units in the HUD inventory are in trouble because of high repair needs or insufficient cash flow.

Recommended Task Force Incentives to Owners to Avoid Prepayment

Owners are motivated by what makes good financial sense, either in terms of converting the property to a more profitable use, maintaining present uses, or permitting default to avoid future losses.

The preservation of the inventory is largely dependent, therefore, on providing the owner with a proper reason or incentive to maintain a project's present low and moderate income housing use. The predominant incentive source will have to be the Federal Government, as it has been in the past.

No one incentive or reason may respond to the needs of the universe of properties involved. There will be a need for a combination of incentives, in order to provide an appropriate long-term solution.

One or more of the following may be the incentive(s) needed to convince an owner not to opt-out:

Recommended Financial Incentives

1. An Increase in Allowable Distribution
2. Recovery of Accumulated Equity
3. Low-Interest Loans for Capital Improvements

Recommended Tax Incentives

1. Re-establishment of Depreciable Tax Basis
2. Low-Income Housing Tax Credits for Existing Owners
3. Non-Taxable Sale to Public and Non-Profit Entities

Expiring Subsidies Pose the Greatest Threat

It is important that we note that expiring rent subsidies are the major threat to the existing housing inventory. It truly overshadows the threat posed by prepayment. Without assistance, projects either will be placed in severe jeopardy for the lack of any other viable tenant population or forced to look to non-subsidized tenants. In the first instance, default will occur; in the second instance, prepayment is likely to occur. This problem must be dealt with immediately and affirmatively. Otherwise, mortgage assignments and foreclosures, deteriorating physical plants and a massive displacement of tenants will occur.

Recommended Actions to Extend Subsidies

The Task Force recommends that following actions should be taken:

1. All Section 8 LMSA rent-subsidy contracts, which expire prior to prepayment of the mortgage, should be extended by HUD to the maturity date of the original mortgage. In return for this extension, the owner should be required to waive its mortgage prepayment right. It is probable, that the issue of incentives will also have to be addressed at the same time, to induce the owner to give up its prepayment right.
2. When LMSA contract authority and/or budget authority is recaptured by HUD due to non-use, that authority should be recycled and put to use for the benefit of other projects.
3. Discontinue the use of five-year project-based subsidy contracts. Future contracts should be for a term ending on the maturity date of the original mortgage.

In addition, as you heard yesterday, the use of the tax code to encourage low-income housing production is important for the breadth and depth it adds to the arsenal of incentives available.

Tax Policies Should Encourage Preservation

Mr. Chairman ten years ago, even five years ago the possibility of losing these units would not have been of severe as today. However today there is no workable production program to allow us to absorb this dramatic loss. The combined ramifications of the reductions in direct spending for housing and the Tax Reform Act of 1986 are that low income housing production is at a standstill. As was discussed in detail yesterday, the credit program needs improvement, tax exempt bonds for housing have been rendered inoperative with additional state and federal subsidies, and depreciation schedules have been lengthened beyond value.

Obviously this is an issue which tax policy can address. It must be addressed by not only the Ways and Means Committee, but the Banking Committee as well. Again, I congratulate you for realizing this fact, and for joining with Mr. Frank in the authorship of HR3663. As I understand it this bill would restore many of the exhausted tax incentives to the owner of an expiring use project if he is willing to recommit the project for twenty more years. Specifically it would:

- restore an owners original basis thereby initiating a new depreciation period for the recommitted project.
- exclude from taxation the gain on the sale of a project to a new owner who agrees to another 20 year commitment.
- allow the issuance of low-income housing tax credits for qualified recommitted projects.
- liberalize, with respect to recommited projects, the "ten year placed in service rule" which defines credit eligibility.

H.R. 3663 is significant in that it provides the necessary tax relief, in addition to the incentives identified in the 1987 Housing Act, to permit states to develop work-out plans for projects in danger of prepayment

When used in combination with Credits to purchasers, the legislation would encourage transfers of ownership, and subsequent extensions of occupancy and use restriction, by excluding the non-cash gain on sale from taxation. The savings could then be used to address capital needs for development in need of repair and improvements and/or cover taxes on gain for developments whose market value has appreciated substantially.

A review of the MHFA portfolio indicates that approximately 20 of our 56 expiring use developments, representing 3,200 units, have these kinds of physical and financial needs and could benefit from the passage of this legislation.

In testimony presented by Mr. Dennis Blackett, President, HII Corporation, in hearings before this committee yesterday, he indicated the difficulty of attempting to resyndicate developments which had been allocated 1987 tax credits prior to the end of the calendar year. The 1987 tax credits expired at the end of the year and there was unused credit authority which could be utilized in 1988. (The Commonwealth utilized 67% of its 1987 authority). Since Massachusets expects to be over-subscribed for its 1988 tax credit authority, we support Mr. Blackett's recommendation for a carry-forward of the unused 1987 tax credits to 1988. This would permit developments which were unable to complete processing during the first year of the tax credit program to go forward.

We believe that the combination of the benefits provided in H.R. 3663, and the carry forward of 1987 tax credits would permit us to more effectively address the issue of expiring use in 1988.

We strongly support the rapid enactment of H.R. 3663, but again point out that it is not a panacea for our problem. The credit and depreciation will be helpful, but it also is important that the value of the credit be improved if it is to be a truly useful tool in preserving existing housing resources. Yesterday's testimony by Mr. Terrence Duvernay provides specific examples of how the credit could be improved.

Use of the Credit to Preserve Assisted Inventory is Too Limited

The Committee should consider including in the Low-Income Housing Credit statute the ability to use the waiver of ten year ownership requirement for the acquisition credit for:

- HUD/FmHA foreclosed projects;
- federally assisted, uninsured housing finance agency financed projects;
- projects in need of funds to forestall physical deterioration, even if not in financial distress;
- developments in danger of conversion from low-income use; and
- foreclosed or vacant uninhabitable properties that would be substantially rehabilitated for low-income use.

The Value of Depreciation Must Be Increased

Likewise the value of depreciation was minimized by Tax Reform. The Administration and Congress expressed displeasure at the "churning" of properties which resulted from the prior law depreciation schedules. In this instance that so-called "churning is the desired result. I have serious doubts about the ability of 27.5 year straight line depreciation as a tool to entice a recommitment. Rather I urge that consideration be given to restoring 18 year accelerated depreciation to such projects.

The concept of discounting gain from the sale of a qualified project to a buyer willing to recommit is a very valuable tool.

The Housing Act of 1987 Offers a Testing Ground

The recent enactment of H.R. 4 with its inclusion of the state plan provision is laudable. I believe that states will act quickly to establish the requisite plans to utilize these funds.

Finally Mr. Chairman, I would like to close by again stressing the vital link between all forms of low- and moderate-income housing. Preservation, as addressed by the Rangel-Frank bill; multifamily production as addressed by both H.R. 4 and the move to improve the Credit, and; single-family housing as addressed by the Donnelly-Rangel bill . . . H. R. 2640 . . . must all be enacted quickly if our nation's housing crisis is to be alleviated.

I thank the Chair and am prepared to answer any questions.

Mr. Coyne. Mr. Eimicke?

STATEMENT OF WILLIAM B. EIMICKE, DIRECTOR OF HOUSING, NEW YORK STATE DIVISION OF HOUSING AND COMMUNITY DEVELOPMENT

Mr. Eimicke. Thank you very much, Mr. Chairman.

I would like to recognize and thank our Congressman Rangel from New York for all his assistance in our efforts to provide affordable housing in New York State and bring him and you members of the committee greetings from my boss, Governor Cuomo, and express as well his gratitude for your assistance in the past, and hopefully, additional assistance in the future.

Among my responsibilities as New York State director of housing is the supervision of our portfolio of the State's low income public housing and over 100,000 units of State-assisted Mitchell-Lama housing.

We are all well aware of the desperate need for affordable housing across our country. In New York State, an analysis done by my department in 1984 indicated a gap in New York of over one million housing units. Meeting that need has become increasingly difficult in light of the reductions in Federal assistance for housing. As you are well aware, the $30 billion budget in 1980 has dropped to $7.8 billion in the most recently approved budget.

For us in New York, that has meant that we are losing approximately $1 billion a year in Federal housing assistance as compared to only a decade ago.

Efforts in our State and many other States, Massachusetts among them, have brought new innovations and new methods to the housing market. In our State, over $4.4 billion of State assistance has been approved since 1983, and the Governor has proposed another $1.5 billion in our upcoming budget beginning April 1.

But, unfortunately, despite these rather historic commitments by State and local governments to provide affordable housing, we keep running faster and faster just to stay even. I think in that context it really brings into significance the issues that we are here to talk about today.

In New York State in the last 2 years, over 3,000 units of our Mitchell-Lama housing stock have bought out, converted to market rate housing. It is imperative that we, in conjunction with you, develop methods to offset the lure for owners to prepay their mortgages and buy out of affordable Government-assisted housing.

The investment community must view the Tax Acts of 1981, 1984, and 1986 when melded with the Housing and Community Development Act of 1987 with great skepticism. They have numerous, more attractive choices for their investment dollars. The Housing and Community Development Act of 1987 grants incentives to owners of subsidized housing as long as they maintain it in accordance with acceptable standards. But, unfortunately, what most of these incentives could, in fact, do, if not offset, is place a greater burden on tenants.

The Federal Tax Code in the past has and could in the future provide an equitable way to relieve that burden on tenants and lead to the maintenance of affordable housing.

You have my written testimony which details many of the ideas that we believe could better tailor H.R. 3663. I would just like to take a few more moments to, one, applaud Congressman Rangel and the members of this committee who fought for the low income tax credit program; congratulate you on the success of those efforts; and add that we believe the program can work. In fact, we have recently introduced to the New York State Legislature a New York State low income housing tax credit which directly mirrors your program, piggybacks on it, and provides for investors in New York an additional one-third incentive to use that credit to help preserve affordable housing.

Specifically with regard to H.R. 3663, we believe four basic changes need to be made to streamline the program and make it work more effectively. One is that the current annual test should be eliminated, and there should be one 3-year window for utilization of the credit.

Second, the passive activity concept for low and moderate housing should be eliminated; and for specific wording, I refer you to Senate 1257 as introduced by Mr. Kerry of Massachusetts.

Third, we believe we need somewhat more flexibility in the definition of income limits for the credit as there are variabilities with regard to affordability among the jurisdictions across our country.

Finally, a rather minor change, the Government-assisted definition needs to be broadened somewhat so it would account for various subsidiaries and instrumentalities of local Governments that finance low and moderate income housing.

I thank you for the time and am willing and anxious to answer any questions you might have.

[The statement of Mr. Eimicke follows:]

Statement by William B. Eimicke
New York State Director of Housing
before the U.S. House of Representatives
SubCommittee on Select Revenue Measures
of the Committee on Ways and Means
Room 1100 Longworth House Office Building
Washington D.C.
Thursday, March 3, 1988
10:00 A.M.

I want to thank Congressmen Charles Rangel and Barney Frank and the members of the SubCommittee for this opportunity to testify on the problem of maintaining the stock of governmentally-assisted low-income housing, both rental and cooperative, and to discuss the important role which the federal tax code can and should play in preserving low-income housing.

My name is William B. Eimicke. I am the New York State Director of Housing. As State Director of Housing I am responsible for the supervision of the management of the State's low-income public housing and 100,000 units of State-assisted Mitchell-Lama housing units, the administration of the rent regulatory system and a vast array community development programs.

In January of 1988 Governor Mario M. Cuomo placed before the New York State Legislature and the general public the largest housing capital budget in the history of the State. His budget proposal calls for a housing program in excess of $1.5 billion to produce approximately 40,000 new and rehabilitated units of housing for low- and moderate-income families. Even for the State of New York these are big numbers.

Larger still, however, is the depth of the housing need in New York State. In 1984, a housing gap of approximately one million units was identified in New York State. Since then we have had to redouble our efforts to address this need.

In New York State, and in states across the nation, new programs had to be developed to buffer those in need of affordable housing from the Federal government's callous cuts.

In 1985 Governor Cuomo signed into law the creation of the Low Income Housing Trust Fund and the Affordable Homeownership Development Corporation. Each of these has been funded at an annual appropriation of $25 million. And yet for all our innovative programming we have lost more than 3,000 units of affordable housing through "buyouts." How can we justify spending millions of dollars to produce housing when our existing affordable housing stock is slipping away faster than it can be replaced.

For the State of New York it is imperative that we address the lure of prepayment of mortgages on government-assisted housing.

So far seven developments have come out from under State supervision: Ridgemont Park Apartments (240 units) in Rochester, Greenwood Estates (41 units) in Monticello, Brightwater Towers (738 units) and Field Apartments (1,321 units) in Brooklyn, Bridge Apartments (960 units) in Manhattan, Ballantyne Gardens (120 units) in Syracuse and Mark Terrace (209 units) in the Bronx. These development were part of the State's Mitchell-Lama portfolio.

The State Mitchell-Lama program was created in response to a severe statewide housing shortage.

In 1955 the State of New York responded to the need for middle-income housing by enacting the Limited Profit Housing Companies Act, or Mitchell-Lama Law. This landmark act authorized the State to provide direct mortgage loans to private developers. Long-term, low-interest loans combined with real property tax exemptions fostered production of middle-income housing. In subsequent years, the State's public benefit corporations, the New York State Housing Finance Agency (HFA) and the Urban Development Corporation (UDC), rather than direct State loans financed Mitchell-Lama developments. Under the program almost 105,000 apartments were developed.

Owners of housing developments aided by loans after May 1, 1959, may prepay their mortgage after the development has been occupied for twenty years. (Projects aided by loans prior to May 1, 1959, may be prepaid after thirty-five years of occupancy and only with the consent of the Commissioner.) Once the mortgage is paid the development is removed from the Mitchell-Lama program. When the buyout occurs the rents charged are no longer regulated by DHCR, and the mandate that the apartments be occupied by moderate income families is no longer in effect.

To address the prepayment issue with the limited weapons at our disposal, the Cuomo Administration has taken the following bold steps:

-on April 24, 1986, we issued an opinion finding that Mitchell-Lama rental developments which are bought out from State or City supervision become subject to any rent stabilization regulations effective in the area;

-on July 17, 1986, we issued an Advisory Memorandum finding that State-assisted Mitchell-Lama cooperative housing developments must conform to the requirements of the Department of Law prior to converting to private cooperative status. Thus, an offering plan must be accepted for filing by the Department of Law prior to any action by the Board of Directors to effectuate dissolution of the corporation;

-we June 29, 1987, Governor Cuomo called upon the Legislature to adopt a bill on the buyout issue;

-on July 20, 1987, Governor Cuomo announced the filing of emergency regulations covering procedures for the buyout of rental and mutual (cooperative) Mitchell-Lama developments. These regulations have recently been upheld in the courts; and

-last month the Governor proposed legislation to address this issue.

But the problem transcends our Mitchell-Lama program. The Federally-assisted housing is equally at risk.

Our traditional partner in delivering affordable housing incentives to low- and moderate-income families had been the Federal government. We have lost that partner on the production side. I am here today to argue that we can not afford to lose that partner in our efforts to hold on to that precious stock of affordable housing which already exists.

As you know, the Economic Recovery Tax Act of 1981, the cornerstone for the Reagan agenda, for the first time since 1969 did away with the differential between subsidized housing and other more profitable forms or real estate investment.

The one avenue it did leave open to subsidized housing was the ability of original owners through the mismatching of cash and accrual tax accounting to be compensated through the use of secondary financing for built-up capital value. The importance of this cannot be overlooked as the subsidized housing stock ages. The resyndication vehicle created out of the 1981 Tax Act did not simply allow private sector wealthy investors to make out, but provided a source of funds, when constructively put to use through a thorough and thoughtful housing program, to improve living conditions in affordable housing.

This one ray of light was struck down in the Tax Reform Act of 1984. To the extent that any interest in investing in low and moderate income housing remained, the 1986 Tax Act put an end to that and actually punished the investors who joined in and attempted to maintain affordable housing during the early 1980's.

Now that the financial benefits of investing in subsidized housing or maintaining subsidized housing have been taken away, and people have been punished for using the incentives that the government gave them in 1981, a dilemma is now posed. If it no longer makes sense to own the housing, or maintain the housing, now it has been made impossible to sell the housing or dispose of the housing at its highest and best use.

The investment community must view the Tax Acts of 1981, 1984 and 1986 (especially the retroactive nature of the 1986 Tax Act) with great skepticism. They have numerous other choices for their investment dollars. But what has happened to the tenants?

The Housing and Community Development Act of 1987 grants incentives to owners of subsidized housing as long as they maintain it in accordance with an acceptable set of standards. The most significant of these incentives are an increase in allowable distributions, inflating equity base of calculating limited distributions, increased access to residual reserve accounts, insured second mortgage that might allow a take out of 90 percent of equity, increase in Section 8 rents, and broader use of flexible subsidy loans.

What all these incentives have in common is they either directly place a greater burden on the tenants or the Federal Treasury. We, on the State level, have proposed similar legislation. Our excuse is that we do not have available to us the greatest tool of all, the Tax Code.

The history of the subsidized housing in this nation has been based upon the use of the Internal Revenue Code and, therefore, spreading the cost of subsidized housing across every person in this land and not just those who can afford it least.

According to the Code, the primary benefits available to partnerships who invest in subsidized housing is to allow the individual partners the ability to offset their other income by losses or credits generated from their investment in subsidized housing property. Since the production cost is normally covered by highly leveraged non-recourse mortgage financing, the partnerships may take benefits many times the original equity investment.

The State Committee on Banking and Currency of the 90th Congress (1968) probably summarized the concept best:

> "The partnership arrangement makes it possible to assure an adequate return to investors. Under existing Internal Revenue Service regulations and rulings, partnership losses for tax purposes flow to the individual partners. In the case of new housing units financed on a 10 percent equity -- 90 percent debt basis, the annual accelerated depreciation of the building cost results in substantial book losses during the initial 10 years are the project is built. Assuming the member of the partnership is in a relatively high income tax bracket, his share of the depreciation losses, plus cash income from project operations would provide an after-tax return on his investment which would compare favorably with the return which most industrial firms realize on their

equity capital."

In essence, people are willing to invest money to "lose" money. Obviously, this is a position contrary to basic tax disciplines. Therefore, I believe some background on the legislative history of the "tax shelter" concept is appropriate.

The 83rd Congress of the United STate (1954) first addressed the realization that negative economic results maybe an appropriate an acceptable reason and reward for investing in subsidized housing, by establishing section 167 of the Internal Revenue Code (the Code). This section allowed the accelerated write-off of the costs of constructing housing in the United State. In 1969, the 91st Congress first addressed the problems of providing for different methods between conventional real estate investments and subsidized housing. In the Senate Committee report they stated:

> "Another problem with the present depreciation provisions is that they provide the same tax incentive to all real estate construction. This, in fact, tends to discriminate against the less profitable investments, particularly low income housing. In the 1968 Housing Act, the Congress expressed its desire to stimulate construction in low- and moderate-income housing to eliminate the shortage in this area, and, in part, based the incentive program thereby, provided on the existing tax incentives. In the housing field, the tax stimulus has been more effective for luxury- and middle-income rental housing where profitability and appreciation prospects relative to risk are inherently more attractive than in lower income housing. The 'trickle down' supply effect for the lower income rental housing market is slow and uncertain. Capital and other resource demands engendered by the existing tax stimulus tend to expand luxury housing, commercial, office, motel, shopping center and other forms of investment, squeezing out lower income housing...The Committee agrees with the House that the current tax incentive aspects of real estate depreciation should be reduced, except as to new residential housing. In addition, it agrees that it is appropriate to encourage rehabilitation expenditures on low- and moderate-income rental housing."

When Congress was queried again, the Senate Committee Report during the 94th Congress, 2nd Session, (1976) reported:

> "In the Housing and Community Development Act of 1974, Congress expressed its desire to stimulate construction in low-income rental housing to eliminate the shortage in the area. However, the special tax incentive for rehabilitation expenditures for low-income rental housing under present law expired on December 31, 1975. Without this incentive, the remodeling of many high-risk, low-income projects may be curtailed. In order to avoid discouraging this rehabilitation, the committee believes that the special depreciation provisions for low-income housing should be extended."

In the House Committee Report during the 95th Congress, 2nd Session (1978), it was reported:

> "The special tax incentive for rehabilitation expenditures for low- and moderate-income rental housing under present law expires on December 31, 1975. In order to avoid discouraging this rehabilitation, the committee believes that the special depreciation provision for low-income rental housing should be extended for an additional three years."

In order to protect the needy, the National Housing Act established a limit on the amount of cash flow profit a subsidized housing complex could earn. Congress, during a 24-year period, established a method to encourage investment in subsidized housing. The method was to grant tax deferral benefits to the owner of low- and moderate-income housing in lieu of substantial capital appreciation and cash flow distribution. In 1978-79, the Treasury Department attacked the special tax treatment of subsidized housing. They also attacked the non-application of Section 183 (Lack of Profit Motivation) of the Internal Revenue Code of 1954, as amended, to subsidized housing. After numerous discussions and meetings with the United States Department of Housing and Urban Development, the Treasury Department issues Revenue Rule 79-300. This Revenue Rule addressed the non-profit activity of low- and moderate-income housing, including construction and operation of an apartment project for low- and moderate-income housing under Section 236 of the National Housing Act, and ruled it as an activity to which section 183 of the Code should not apply.

The overriding goal of the Department of Housing and Urban Development is stated in the Declaration of Policy of the Housing and Urban Development Act of 1968 (Section 2, Public Law 90-448):

> "Congress affirms the national goal, as set forth in section 2 of the Housing Act of 1949, of a 'decent home and suitable living environment for every American Family'."

Once again, we at the State level have a universal goal to accomplish. But, we have limited resources to assist our journey. We can sit back and wring our hands, or we can move forward using creative, innovative strategies to effect what Congress affirmed twenty years ago.

While the Housing and Community Development Act of 1987 and our own proposal on the State level seek to provide financial incentives for owners to prevent the loss of affordable housing through prepayment we do not believe that these concepts work by themselves. If rents are increased to cover the incentives imposed, it will be virtually impossible to mix very low, low- and moderate-income tenants in the same historic proportions. Additionally, large rent increases will not only have a negative impact on the tenant's ability to pay, it will in most cases, reduce the number of tenants, and therefore, the number of units which qualify for tax credits under the Internal Revenue Code of 1986. This, of course, decreased the amount of private sector equity available to address physical and financial concerns of the property.

We at the State of New York feel we have been as creative as possible in the use of the vehicles allowed to assist such housing. Since Governor Cuomo took office in 1982, the State of New York has invested billions of dollars in various programs to accomplish these goals. While I could spend a better part of the day reviewing the Governor's accomplishments and vehicles that he has placed into law, no one series of examples will hole true for each case.

Unfortunately, the adoption of the Tax Reform Act of 1986 (TRA) has had a significantly adverse impact on the ability of the State and others interested in preserving low and moderate income housing to attract necessary private sector capital to maintain the projects in a decent, sanitary condition and pay basic operating expenses.

We feel that the inability to raise needed capital will result in further deterioration of this valuable housing stock which cannot be replaced at any reasonable cost. The elimination of federal housing programs for low income tenants and hugh increases in the cost of producing these units has made the maintenance of the valuable assets which are represented by these existing projects all the more imperative. It makes no sense not to preserve these valuable housing units.

New York State is large and diverse and made up of significant urban and rural areas. The result of course if that the problems faced by our state in many ways reflect the diverse problems of creating and maintaining housing throughout the country. The varying cost, needs and peculiar circumstances facing the needy throughout our state only supports the general notion the significant and flexible responses to the problem of maintaining affordable housing must be pursued at the federal, State and local levels.

New York State has never shirked its responsibility to be in the forefront of developing and maintaining housing for low and moderate income people. Well before the policies of the current administration directed more and more responsibility for housing reduction and maintenance to the states, New York State had made significant and innovative contributions to the cause of producing and maintaining its low income housing stock. That commitment has increased dramatically in recent years with programs from state and local levels committing hundreds of millions of dollars of State and local funds to this effort.

The task and the cost of housing, however, is one which cannot be borne by the states and localities alone. This fact clearly was recognized by the Congress in connection with the adoption of the TRA in at least one respect. While the devastating impact on rental housing was clearly felt in the context of changes to the laws relating to the treatment of passive losses and the extension of depreciation with respect to rental property, the adoption of the low income housing credit signaled a continuing federal concern and commitment to housing of low income americans. We of course applaud this continued commitment but our concern is that the credit may be too small, riddled with requirements which make it inefficient and therefore expensive and perhaps too narrowly drawn to meet the needs of low income renters.

We also note that there are many important changes included in the Technical Corrections Act passed by the House of Representatives last year which are critical to the effective use of the low income credit. We urge the adoption of those changes at the earliest possible time.

We applaud Congressman Rangel's herculean efforts to secure adoption of the low income credit program in the first instance and again congratulate you in your recognition of the need to refine and better adapt the credit to meet its intended purposes. Accordingly, we are pleased to have the opportunity to comment on the provisions of H.R. 3663 which Congressmen Rangel and Frank introduced on November 19 of 1987 (The Bill). The Bill, which is aimed principally to promote maintenance of low income housing projects is an important step in the process of preserving our existing housing stock.

Mr. Chairman, it is H.R. 3663 that you and Mr. Frank of Massachusetts introduced that provides us some ammunition for that arsenal. It is my understanding that H.R. 3663:

- Restores the basis in a building that the owner agrees to maintain as a low or moderate-income building for a 20 year period. The owner would be required to insure the building was in good physical condition before he could secure tax relief. This will allow the owner to use depreciation deductions and tax credits for the building although it has already been depreciated.

- Allows low-income tax credits to be issued to owners who will agree to maintain their buildings for low-income tenants.
- Allows the seller of a subject building to exclude from gain the non-cash gain (the gain equal to his remaining mortgage obligation) if it is sold to an owner who agrees to maintain the building as low or moderate-income for 20 years.
- Waives the 10 year holding period for eligibility for the low-income housing credit where a sale would avoid default or where the building was taken in default by a government agency during the last 10 years.

Based on numerous discussions with the private sector and restructuring of many existing loans, I believe that the above provisions with the following modifications when combined with the Housing and Community Development Act of 1987 and our State legislation, completes a cycle that will accomplish your goals. The modifications I suggest are:

1. Instead of three annual tests for the use of tax credits, each state should be allowed to allocate tax credits at any time during one three-year window. Since each state is limited to a total amount of tax credits in the Internal Revenue Code of 1986, it should have no budget impact.

2. For the purposes of investment in low and moderate-income housing and the rehabilitation of projects, the term passive activity as defined in the Internal Revenue Code of 1986 should not apply. Once again, as the amount of tax credits available to each state is limited by the Internal Revenue Code of 1986, this change should not have any impact on the budget deficit. For purposes of wording, I draw your attention to S. 1257 introduced in the Senate of the United States by Mr. Kerry of Massachusetts, page 8, commencing with line 8.

3. Incentive plans of action as defined by the Housing and Community Development Act of 1987 requires retaining the existing units for low and moderate income families, especially "...current tenants are not involuntarily displaced..." We believe generally that one major problem with the low income tax credit is the income limitation formulation's failure to account for differences between costs and median income levels in different jurisdictions. Eligibility should be based on relative affordability which cannot be measured by a percentage of median income alone but must be viewed in the context of the relationship of median income to the cost of housing in each jurisdiction.

4. "Government-assisted building" is defined to mean any building that is substantially assisted, financed or operated under any Federal, State or local housing program. The definition should be amended to provide that "Federal, State or local" includes any of their subsidiaries or instrumentalities. Additionally, the Bill should clarify that the phrase "assisted, financed or operated" does not require the project to be insured or otherwise assisted by the Federal Government. Any housing projects receiving State or local assistance or Federal assistance but no Federal insurance should be treated as "assisted, financed or operated" under a Federal, State or local housing program.

5. The Bill requires among others, that a partnership contribute the capital required to repair and restore the project to a sound physical and financial condition. While we appreciate that the partnership should be required to contribute capital, the language of this section implies that assistance from other sources is not permitted and should be amended to reflect that a project acquired by a partnership can receive, for example, local grant funds with Violating Code Section 135.

6. Under the Bill the "qualified low income housing project can be sold after a five-year holding period. For a project to be eligible for the low income credit, however, there must be a ten-year period between placement in service. While the Bill provides an incentive for sellers, there would be no incentive for buyers to purchase the building unless they had the potential of receiving the credit. That potential can be there only if the credit rules are amended to provide that projects purchased from sellers who received the benefit of Code Section 135 are eligible for the credit without regard to the ten-year holding period rule. Additionally, qualification as "qualified low income housing" is required to secure restoration of the property's basis for the building to be eligible for the low income credit. As drafted, the building would be required to be subject to restrictions on rents or income for at least a 20-year period. The credit rules require a 15-year compliance period. The 20-year restriction period should be reduced to 15 years to eliminate the inconsistency between these sections.

With respect to the problem we face with our limited-equity co-ops I have two modifications to your proposal:

1. The term "limited equity cooperative housing corporation" should be expanded to include those cooperatives which are substantially assisted by Federal, State or local programs, wherein the carrying charges, equity contributions, income eligibility, and resale value of the shares is regulated.

2. State and local grants, and insurance proceeds awarded for the purposes of repairing or maintaining the limited equity project should not be classified as "non-membership income".

In essence, Mr. Chairman, your Bill goes back to basics as originally contemplated by the Congress of the United State in 1954, and makes decent housing a national investment and not a national disgrace. If we are to win the fight to maintain and create affordable housing, we must once again use the most effective tool available, the Tax Code. HR3663 brings us back to the concepts which have produced the housing we are seeking to preserve. Mr. Chairman, Mr. Frank, your efforts should be applauded by all involved in this struggle.

Mr. COYNE. Thank you both very much.

Mr. Siflinger, Mr. Eimicke has given us his views as to how the Tax Code should define low income. I wonder if you could comment on how the Tax Code should address this issue.

Mr. SIFLINGER. Well, we feel the people we are seeking to protect have been categorized in the past and in these programs as low and moderate income tenants. To include the tenants in the (d)(3) developments that had eligibility criteria of 95 percent of area median is, I think, particularly helpful. In a State such as ours and in many of the other States, this moderate income band of tenants needs help. There is no affordable housing out there that they can turn to.

Mr. COYNE. This morning GAO urged that the tax incentives in H.R. 3663 be tightly targeted. Do you have any specific suggestions as to how tax incentives designed to preserve the stock of low income housing should be targeted?

Mr. SIFLINGER. My feeling is that the recommendations of GAO are too restrictive; that the problem that we have in many of our States—and I am sure Bill would agree—is that the incentives should be directed so that the owners will continue to provide low and moderate income use. The restrictions of 50 and 60 percent of income clearly help the most needy, but clearly ignore the need that those families with an income up to median income or, certainly, 95 percent of median income—the previously eligible (d)(3) tenants—it ignores that particular need.

And if we do not provide that kind of incentive to the owners to assist this kind of tenant, we must look at the low vacancy rates that we have in many of our States. And we find that these tenants cannot be absorbed elsewhere if such units are converted to market rate housing.

Mr. EIMICKE. I can only echo that point. In our largest city, New York City, the vacancy rate is variously estimated below two percent, but in many cases down to nearly zero. And with the cost of new housing estimated at at least $125,000 per unit, I think anyone would be hard pressed to say that there is not a need not only at the very low income, and certainly greatly there, but all the way up to what we would classify as middle income. There just are not any other options for the families living in these units right now. If these units go away, they will be displaced.

Mr. COYNE. Well, thank you both for your testimony.

We will recess in order to vote. We will reconvene after the vote.

[Recess.]

Chairman RANGEL. The committee will resume its hearing.

We are honored to have the presence of Congressman Barney Frank, who has been creative and innovative in housing legislation. I congratulate him on his recent success with his committee and thank him for his ideas in helping us to craft tax incentives in order to preserve existing housing stock.

I want to tell you that the support and enthusiasm was far greater than I ever thought it would be when you and I first talked about this. You should know that HUD is willing to work with us to see whether or not this concept can be incorporated in their housing policy so that we can get support for it. At least that is the beginning.

Your statement, of course, is going to be entered into the record without objection, and we are glad that you found time to share your views with us. Mr. Frank.

STATEMENT OF HON. BARNEY FRANK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. **Frank**. Thank you, Mr. Chairman. I appreciate your accommodating me. I had another hearing I was presiding at, and I will be brief because I do not want to displace the other witnesses. I guess that word is in my mind.

I want to say very seriously that low income residents of subsidized housing projects are very lucky that you happen to be in this chairmanship right now, because the Ways and Means Committee is in a position, I think, to take more effective action to avert the loss of subsidized housing. And having someone as sympathetic as yourself and who has devoted the attention to it that you have done is encouraging.

I am glad to hear what you said about the enthusiastic response. I think what happened, frankly, is that once it became clear to people that you were serious in your capacity as chairman and with your colleagues—and I know the gentleman from Long Island has also been very concerned about this because of a project in his own area—I think that kindled some enthusiasm. People do not want to spend a lot of energy if they do not think it is going to get anywhere. But knowing that you are serious I think is very helpful.

Let me just say with regard to both sets of hearings, I do think we need to fix the tax credit some. I congratulate you for the work you did back when we passed the bill in 1986. We would have been a lot worse off had it not been for yourself and a couple of other members who understood the impact on multifamily housing construction. And I think there are some reasonable points made, at least about carryovers and some other things, that can be done with very little if any, negative, impact on our revenue system. We can get more housing per dollar by some of these changes, as you know, than in any other place.

With regard to the bill that you have taken the lead on and on which I have joined you, I know it is very relevant to other people. I just mentioned that Steve Bartlett from Texas, who is one of the leading Republican members of the Housing Subcommittee, joins us on this. I know you have support from Mr. McGrath and others on both sides. By adding this one more incentive, I think we can do a great deal to avert a very serious loss of housing.

We all know that in the current budget situation we are not able to build the new units that you and I would like to see built. We may be for building new units but we just do not have the votes to do nearly what needs to be done. That makes preventing the loss of existing housing enormously important.

The homeless people in this country did not come from Mars. They are Americans who used to live some place. Many of them are the kind of people who used to live in this kind of housing. And if we are not able to do some of these things, we are going to be adding to the homeless problem.

What we did in the housing bill, as you know, is to provide some incentives as well as some restrictions. But we are dealing here with prepayment with the fact that a program was designed before you and I got here that gave owners a contractual right to do certain things. We cannot simply prevent them from exercising that contractual right. I believe we can constitutionally condition it in some ways, but we cannot simply abrogate it.

We, therefore, need some incentives, and this one, providing a tax incentive to people who will voluntarily guarantee that we get 20 more years of subsidized housing for low and moderate income people, is by far the most cost-efficient way to provide units that would otherwise not be available.

I think it is a very sensible idea. People have proposed some suggestions and changes. I want to congratulate your staff as well, Mr. Chairman, as they have done excellent work. I hope we are going to be able to come out with a package that I think will have no negative impact on the Treasury.

I know when we asked CBO about this a year ago, they did not say it was going to cost us anything because this is not revenue they have been counting on in terms of their revenue projections. As a matter of fact, the prepayment is going to make more money for them than they realize. And all we are saying is they may not make quite as much more money as they had anticipated. We are not going to exacerbate anybody's deficit projections.

So thank you for your interest and your work, and I am finished with my statement.

Chairman RANGEL. That is great. We have to get our team back to the drawing table to see what we have to do, really, to get HUD support. But I want to really thank you for the leadership that you provided.

Mr. MCGRATH. Thank you, Mr. Chairman. I want to thank our colleague from Massachusetts for being a leader in the Congress in the fight for low income housing and the use of the tax credit for those means. I pledge to you, that I have quite a few low income housing units in my district. We would like to see some more. Even in a district as wealthy as mine, there are some areas that need these kinds of units for people to live and live well. We will be working together on this particular issue.

Mr. FRANK. I appreciate that. I appreciate the help you have given us so far.

Thank you, Mr. Chairman.

Chairman RANGEL. Thank you.

Our last panel is Mr. Heller, J. Roderick Heller III, president and chief executive officer, National Corporation for Housing Partnerships; Terry Lewis, president of the National Association of Housing Cooperatives; Bruce Rozet, chairman of the board, Associated Financial Corp., Pacific Palisades, Calif.; and Barry Zigas, president of the National Low-Income Housing Coalition.

Your statements will appear in their entirety in the record, and you can proceed as you feel comfortable. We will start with Mr. Heller from the National Corporation for Housing Partnerships.

STATEMENT OF J. RODERICK HELLER III, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS

Mr. HELLER. Good morning. I am Rod Heller, president of the National Corporation for Housing Partnerships. I am pleased to be with you this morning. We have submitted a statement for the record, which largely includes our technical comments with respect to the legislation that you have proposed, Congressman Rangel.

I would like to depart from the written materials that we have presented and try to put in context some of the changes that we believe the Nation confronts in grappling with the preservation issue.

First, I would like to stress the lack of data that thus far has characterized the debate. We at the National Housing Partnerships are trying to remedy that through the National Low Income Housing Preservation Commission. With $400,000 that we have expended and a $250,000 grant from the Ford Foundation, the National Low Income Housing Preservation Commission has developed a detailed data base dealing with 645,000 section 236 and 221(d)(3) projects. The model prepared by Act Associates of Cambridge, Mass., includes a projection of the number of units in that category of project which will default, the number that will prepay, and the cost to prevent the loss of that housing stock to the country.

We will be submitting, Congressman Rangel, that report to the House and the Senate Subcommittees on Housing, both of which have requested us to do so last year. I believe the findings will be illuminating and very helpful to your committee.

Second, I would like to outline very briefly some factors which I believe are all too often lost in the focus on the preservation issue. Those factors relate to the impact nationally of the Tax Reform Act of 1986. The low and moderate income housing units, the 2 million federally subsidized but privately owned units, are by and large owned by limited partners which invested literally billions of dollars in those projects, and general partners which typically were large apartment owners and syndicators. I think it is useful to look at both categories, taking the latter first, the general partners.

We recently completed, for our own board at the National Housing Partnership an evaluation of the financial condition of the general partners. Of the top five owners of low and moderate income housing at the end of 1985, two are in bankruptcy; a third has withdrawn from that field of activity; and only Mr. Rozet's company and the National Housing Partnership remain as major owners and operators of that type of housing.

Perhaps more significantly, of the 25 top apartment owners generally—that is, owners of conventional as well as low and moderate income housing—at the end of 1986, 10 are bankrupt or in serious financial trouble. The whole industry is in significant disarray, occasioned not only by tax reform but by overbuilding and the other factors that have affected the economy.

This is going to have ultimately a significant impact on the prepayment issue, on the production of rental housing in this country, and obviously on the construction industry.

Turning to the second category, the investor group. Since 1968, when the bargain was struck, investors put up equity dollars for low and moderate income housing projects in return for tax benefits. No cash-flow is, by and large, to be expected from these projects, and appreciation is uncertain at best. As a consequence of the 1986 Tax Act, investors no longer are receiving any benefits to speak of, and they confront the specter of ownership of an investment locked in for the next 8 to 10 years without any economic return.

This poses for fiduciaries like NHP significant difficulties. While I believe that we can legitimately argue that low and moderate income housing can be preserved to some limits without regard to the fiduciary obligations we have, the loss of flexibility in protecting the investors is a very significant one. And we are seeking means of providing protection for the investors.

We are very enthusiastic supporters of your bill, Mr. Rangel, because we believe it offers one way for general partner fiduciaries to offer investors an alternative. At NHP we are establishing a nonprofit, 501(c)(3) to which we hope many of the investors in our 60,000 low and moderate income housing units will contribute or sell on a bargain sale basis their interest as a means of escaping what has no longer proved to be a useful investment. At the same time, we can ensure that the housing originally developed with those dollars will remain in the national stock of low income housing.

Your bill, while we have some technical objections to it—which as I have said are set forth in the testimony—we find a very useful initiative and one we completely support.

Thank you.

Chairman Rangel. Thank you, Mr. Heller, and congratulations on the fine work that you have been doing. We look forward to continuously working with you.

[The statement of Mr. Heller follows:]

STATEMENT OF J. RODERICK HELLER III, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL CORPORATION-FOR HOUSING PARTNERSHIPS

I am pleased to appear before this Committee on behalf of National Corporation for Housing Partnerships. NCHP is unique, a private, for-profit entity created by Congress in 1968 with the purpose of encouraging the development of low and moderate income housing.

Today, NCHP

- owns more low and moderate income multifamily rental housing than any other private entity,
- is the largest manager of low and moderate income rental housing, directly managing 55,000 units, and,
- has not yet returned a single multifamily mortgage to HUD--an accomplishment requiring not only dedication and hard work, but almost $50 million in loans to projects.

We are privately owned (with Berkshire Hathaway and Weyerhaeuser being our principal shareholders) and operate on a national scale, with over 500 rental properties located in 39 states, the District of Columbia and Puerto Rico.

NCHP has carried out its original mission by using $650 million of private funds, raised in large part from investors in private and public real estate partnerships, to develop over 80,000 units of low and moderate income housing. Nationwide two million units have been built through private funding. NCHP believes that the interests of these investors were forgotten during Congress' consideration of the 1986 Tax Reform Act and has been forgotten thus far during Congress' consideration of the preservation issue.

Traditionally, there are three benefits derived from a real estate investment: (1) cash flow, (2) appreciation in value and (3) tax benefits. An individual investing in a low income housing property does not expect to receive cash flow, and appreciation is, at best, uncertain. The primary benefit then, is tax benefits designed to provide the equivalent of an economic return on investment. Tax benefits were the primary reason private investors invested in low income housing.

The effect of the Tax Reform Act of 1986 on low income housing and its residents was devastating--not only with respect to these investors, but with respect to the future production of such housing and the preservation of existing housing. I need not emphasize that the legislation had a retroactive impact on currently owned projects by taking away most of the tax benefits associated with investments in such projects. By undoing the bargain struck with private investors in low and moderate income housing, Congress has further jeopardized our existing housing stock. With little or no cash flow ever expected from these properties, and little or no tax benefits remaining after tax reform, owners are now encouraged, where possible, to sell their projects for economic gain or, if that is not possible, perhaps to abandon their troubled properties.

This is particularly important for NHP and other similarly situated general partners in low and moderate income housing. NHP is a fiduciary and legally obligated to obtain the highest possible return for our investors. We believe that, because of our unique congressional status and the emphasis we placed on low income housing, we have some flexibility in balancing investors' needs with our interest in maintaining as much as possible of our stock of low and moderate income housing. But Congress has made our task much more difficult. Our investors typically are receiving no benefits from their investments.

To demonstrate this impact, I'd like to share with you a portion of a letter I received from one of our investors:

> Dear Mr. Heller:
>
> * * *
>
> [I]t really appears that the 1986 tax changes have turned an anticipated nice investment into a financial disaster. I am also aware of the fact that you are under contractual obligation to maintain the low income status of these units and I would assume, therefore, that the chance of any reasonable return on investment is remote at best. I would appreciate comments on this.
>
> Finally, if I am not making any return on investment, what are my prospects of a sale of my interest? I seem to recall that the original Memorandum did show a planned sale with the profits to be derived from that sale as the benefit from the program. If this is true, when is that sale planned and how can we expect profits from this sale if the five properties involved, which are fully rented, are not earning enough money to pay us income?

The Low Income Housing Transition Rule included in the 1986 Tax Act provided some relief from the law's passive loss rules, but only to a relatively small number of low income projects and their investors. In that sense, the Transition Rule has served as a successful vehicle in avoiding an early wave of lost projects. Without it, the scope of our concern this morning surely would be broader.

NCHP has two principal concerns: on the one hand we are a general partner and fiduciary with obligations to those who have invested in our properties. On the other hand, we were established by Congress to promote low income housing and are deeply concerned by the prepayment issue. We think that the critical action that must be taken now is to restore tax benefits that will facilitate the retention of properties as low income housing. To that end these hearings and your proposed legislation, H.R. 3663, are a very constructive beginning.

We generally support the objectives of this legislation. However, we feel some of the specific provisions will not achieve those objectives. We also support an increased role for nonprofit entities in preserving low income housing. Congress needs to recognize that these nonprofit entities have the same need to raise capital through tax incentives that for profit entities do. We would further suggest that Congress give consideration to supporting partnerships between for profit and nonprofit entities to meet that need. Our reservations about H.R. 3663 are as follows:

- Increase in Adjusted Basis.

  We support the purpose of this provision to both preserve a property as low income housing and to improve its physical condition. However, we must oppose its specific provisions because we do not think they will achieve that objective. As drafted, the bill would permit an owner to increase its adjusted basis in a property and to be eligible for the Low Income Housing Tax Credit in return for (1) its agreement to continue operating the property under its existing use restrictions and (2) its agreement to restore the property to sound physical and financial condition within 24 months. Because there is no ability to obtain additional capital from the limited partners, the responsibility to fund the required repairs would fall solely on the general partner. Practically, most general partners would not have the financial ability and, under current tax allocation rules, will not receive the tax benefits as an incentive to make such repairs. On the other hand, the limited partners who will contribute no additional capital and who typically hold 99% of the partnership interests would, therefore, receive the benefit of the Low Income Housing Tax Credit. Moreover, no owner would agree to maintain the low income status of the property without an extension of the property's subsidies.

  If one of the purposes of this provision was to also address the so-called "phantom income" problem, we suggest that a better remedy to assist investors and encourage low income housing preservation would be a passive income limitation rule. Such legislation would, in effect, put investors in a cash basis position by requiring them to report only the amount of actual cash distributions received as income.

- Low Income Housing Tax Credit.

  We support the provision in the bill which would permit a waiver of the credit's ten year placed in service rule if necessary to enable a project to be retained for low income housing. We believe this is a good provision because it increases the involvement of State and local governments in determining when to allow the credit for projects financed under state agency--rather than federal--programs and adds preservation as a criteria for granting a waiver.

- Gain Exclusion.

  In general, we believe that this is a very constructive initiative and strongly support the concept. As currently drafted, the bill, however, singles out transfers to a partnership as the only instance in which the purchaser is required to restore the property to sound physical and financial condition within 24 months. A nonprofit purchaser is under no such obligation. We believe such a distinction is both inappropriate and counterproductive to our preservation goal and our goal of providing decent and safe low income housing. We suggest the following two modifications to the provision: first, all nonprofit and for profit entities--including for profit corporations such as NCHP--should be able to benefit by this gain exclusion provision; second, no entity, for profit or otherwise, should be excluded from the bill's requirements with respect to restoring the property to sound physical and financial condition.

As part of our responsibility under our Congressional charter, NCHP has sponsored the organization and operation of the National Low Income Housing Preservation Commission. This bipartisan Commission is independent of NCHP and was established last year with the support of the House and Senate Housing Subcommittees and is chaired by former HUD Secretary Carla Hills and former House Banking Committee Chairman Henry Reuss.

Many industry groups have studied the issues of prepayment and expiring subsidy contracts confronting our existing privately owned low income house stock and have cogently stated their views on the public policy choices Congress should make. The National Low Income Housing Preservation Commission is performing a unique service, unlike that of other groups: (1) it will compile a detailed, credible data base, tracking salient facts on the existing stock of 645,000 units under the 221(d)(3) and 236 programs, and (2) it will utilize a complex financial model to determine the likely future of many low income housing projects, both with or without further legislative action to save them. This data has been compiled and analyzed at no small cost--the Commission has received $400,000 from NCHP and $250,000 from the Ford Foundation. It will release its findings and conclusions to Congress early in April. The Commission's report will address:

- How much of the low income housing stock is at risk of loss to low income households due to prepayments of mortgages;
- How much of the stock is financially troubled and likely to default; and
- The estimated cost of protecting the supply of older, subsidized housing from default or conversion to non-low income use.

I believe the findings of the Commission will be invaluable to this Committee with respect to your analysis of the issues surrounding the preservation of low income housing. I believe our support for this effort exhibits our deep commitment to this issue.

One final note. I believe it is imperative that Congress recognize that if it wishes private, for profit owners and investors to participate in the development of low income housing there is a need for stability and reliability in the tax laws. Current skepticism among private owners is well-founded. Prior to tax reform, Congress struck a bargain with private investors which generally said that investors could reduce their annual taxable income in return for their equity contributions to low income housing properties. In 1986, Congress retroactively and severely curtailed those tax benefits, although in most cases the amount of an investor's equity contribution remains the same.

This stability is equally called for in housing legislation. Approximately 20 years ago the federal government agreed to provide private owners with low interest construction loans and rental subsidies in return for which owners agreed that the property was limited to use by low income residents for at least 20 years. In 1987, Congress retroactively modified the terms of those contracts by enacting the prepayment provisions in the housing bill. We continue to oppose those provisions.

The new low income tax credit requires that a property remain low income housing for 15 years. I submit to this Committee that in today's legislative atmosphere, an owner using the credit today has no idea whether or not Congress really will permit him in year 16 to lift those low income housing restrictions.

I strongly believe that this credibility issue must be addressed if there is to be significant private involvement in this country's low income housing production program in the future.

Thank you, Mr. Chairman, for the opportunity to appear here today. NCHP looks forward to working with this Subcommittee and its staff on protecting our vital resource of low income housing.

Chairman **Rangel**. Terry Lewis, president of the National Association of Housing Cooperatives. Ms. Lewis.

STATEMENT OF TERRY LEWIS, PRESIDENT, NATIONAL ASSOCIATION OF HOUSING COOPERATIVES

Ms. **Lewis**. Thank you, Mr. Chairman.

I thank you for this opportunity to present the views of the National Association of Housing Cooperatives on H.R. 3663. Our organization applauds your desire to preserve the country's stock of low and moderate income housing, and we appreciate your sensitivity to housing co-ops as a source of decent, affordable home ownership. We do, however, seek certain modifications in this legislation.

Last Saturday, I spoke before a gathering of cooperators and legislators from in and around New York City.

Chairman **Rangel**. You did.

Ms. **Lewis**. Yes. You were there, Mr. Chairman. You were our keynote speaker.

In addition, representatives of four NAHC association members representing more than 550,000 area cooperative households were present. You spoke eloquently on the subject of using the Federal income Tax Code to achieve social priorities, most notably maintaining affordable housing stock and avoiding displacement, especially in New York City, of residents who are not the possessors of enormous wealth.

When the Tax Reform Act of 1986 was passed, you acted on behalf of qualified cooperative housing corporations threatened with grossly inequitable tax consequences. The inequity that you prevented stemmed from a section of the Tax Code that is at issue today and that we are asking for your help in dealing with. And that is also dealt with in 3663.

Because of the responsiveness you have shown in the past and the sensitivity that H.R. 3663 shows to the country's housing needs, I am confident we will receive the help and support we need.

Now, I would like to say a little bit about cooperative housing because it is not nearly as well known as the rental housing that you have been talking about. But cooperative housing is, with very few exceptions, affordable housing, not luxury housing. Now, I know you are all familiar with the Watergate, and that may be your image of the cooperative. But in most cases, cooperative housing across the United States is lived in by low, moderate and, at most, middle income Americans.

The Federal Government has an enormous investment in cooperative housing, not only through Government-assisted housing but through Government-insured housing. There is a substantial number of nonassisted cooperatives that are financed by federally guaranteed loans or, in addition, eligible through refinancing under section 223(f).

Now, this is an enormous commitment of the Federal Government to affordable housing stock, in addition to the very small and very targeted group that you have already addressed in your bill. I would like to tell you very strongly that my organization has an enormous number of members who are within the already targeted group. But we are absolutely united in saying to you that housing cooperatives as a whole require protection under the Internal Revenue Code. Housing cooperatives as a whole need your help in order to maintain the stock of affordable housing in the United States.

The major issue and the most predominant issue that you have addressed in your bill is interest on reserves. A housing cooperative is not like a single-family home. The scale of the enterprise is quite a bit large. And unlike a single-family home owner, a cooperative member makes a monthly payment that is allocated to the whole of the cooperative, not to his single dwelling unit. He is responsible for a proportionate share of all of the costs of operating the cooperative, including the cost of paying the mortgage.

Prudent management standards dictate that the housing cooperative make long-range plans to provide for maintaining and eventually replacing its physical plant. Mortgage lenders or Government regulators often require that a replacement reserve and a general operating reserve be maintained to assure that the cooperative's ability to meet these needs over time is maintained. Large scale maintenance and replacement projects like furnace replacement, parking lot repaving, asbestos abatement and the like, require large scale financial investment.

Now, the necessary funds can theoretically be created in three ways. The members can be assessed directly as the rehab occurs. The scale of these projects make this prohibitive for low and moderate income families. That kind of financial wherewithal is not at their beck and call.

The cooperative can go out and seek loans. But cooperatives generally have a first mortgage lender, and the first mortgage lender is not always willing to impair the security of this loan by allowing further debt to be incurred.

Finally, the cooperatives can do what prudent businesses do and what the Government requires that cooperatives do in not only Government-assisted housing, but cooperatives that are financed simply by Government guaranteed loans. That is to accumulate reserves over time.

As monthly payments by the shareholders generate the reserves over time, these funds are deposited in interest-bearing accounts. The interest earned further enhances the cooperative's ability to meet future replacement or operational needs. As you can see, the reserves are an integral part of the operation of the cooperative, and yet the Internal Revenue Service has recently begun to treat the reasonable reserves of housing cooperatives as if these funds were entirely unrelated to the cooperative. Not only do we find this action by the IRS disturbing and unreasonable; it is also unnecessary.

Now, my written testimony sets out a great deal of information about interpretations of the Tax Code and the taxation of cooperatives under subchapter T. What I would like to say is that section 6 of your bill speaks to interest on reserves. It is targeted for what is called limited equity co-ops. The targeting is too narrow, Mr. Chairman. The targeting of that section of the bill must be expanded to include the entire stock of affordable housing that is provided by cooperatives.

Second, your bill addresses the 80–20 rule and commercial income in limited equity cooperatives. We think that for limited equity cooperatives for this targeted group, an enhancement of the incentive is needed, because most residents of limited equity co-ops do not benefit by the ability to take the passthrough. They take the standard deduction. What would be a far greater incentive for limited equity cooperatives would be the ability to use commercial income to reduce the cost of providing housing to their low income members.

We have some additional suggestions for refinements of the bill that are set out in my written testimony. I thank you very much, Mr. Chairman.

Chairman RANGEL. Thank you, Ms. Lewis. You were eloquent Saturday, and you were just as eloquent today.

[The statement of Ms. Lewis follows:]

Statement of Terry Lewis
President
National Association of Housing Cooperatives
Before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U. S. House of Representatives

March 3, 1988

Mr. Chairman and Members of the Subcommittee:

I thank you for this opportunity to present the views of the National Association of Housing Cooperatives (NAHC) on HR 3663. Our organization applauds your desire to preserve the country's stock of low and moderate income housing and appreciates your sensitivity to housing cooperatives as a source of decent, affordable home ownership. We do, however, seek certain modifications in this legislation.

I speak to you today as President of the National Association of Housing Cooperatives and as an individual formed by all of my experiences with cooperatives and affordable housing. NAHC is a nationwide organization of housing cooperators and cooperative professionals. For thirty-seven years, NAHC has provided a forum for training and the exchange of information among housing co-operators, and has served as a spokesperson for cooperative homeowners from from diverse geographic, economic and social backgrounds. I grew up in a Michigan cooperative of which my immigrant grandparents, with eighteen other couples, were founding members and whose current members include both my parents and my closest friend. For ten years, I was a member of a federally-aided housing cooperative in Ann Arbor, Michigan. I served as a member of its Board of Directors, as its Treasurer and as its President. In addition, I am an attorney whose day to day work is on behalf of a substantial number of housing cooperatives, and an even larger number of government-regulated and assisted rental housing projects. All of these experiences inform my words as I address you today.

Just last Saturday, I spoke before a gathering of cooperators and legislators from in and around New York City. Representatives of four NAHC Association members representing more than 550,000 area cooperative households were present. The Chairman of this Subcommittee, Congressman Rangel, gave the keynote address. He spoke eloquently on the subject of using the Federal Income Tax Code to achieve social priorities, most notably, maintaining affordable housing stock in booming real estate markets across the nation and preventing the displacement, especially in New York City, of residents who are not the possessors of enormous wealth.

When the Tax Reform Act of 1986 was passed, you acted on behalf of qualified cooperative housing corporations threatened with grossly inequitable tax consequences. The inequity you prevented stemmed from an interpretation of the tax code recently promulgated by the Internal Revenue Service. As proposed, Section 6 of H.R. 3663 offers similar protection to a very small fraction of the cooperatives that provide affordable homeownership to some 1,000,000 American families. My membership is united in saying to you that this protection must be refined and broadened to allow H.R. 3663 to truly prevent displacement and preserve the country's stock of affordable housing.

Because of the responsiveness you have shown in the past and the sensitivity that H.R. 3663 shows to the country's housing needs, I am confident we will receive the help and support we need.

First, let me tell you a little about cooperative homeownership. I'd like to begin by telling you what it is not. As Washington dwellers you are no doubt familiar with the country's most notorious cooperative, the Watergate. It is a luxury dwelling by any standard. Luxury cooperatives such as the Watergate and a few like it in New York City and Chicago are rare indeed. Most cooperative housing is owned by middle and low income families. Some are former rental properties converted to cooperatives by their tenants. Many were newly constructed with government guaranteed loans, some with goverment subsidies. With few exceptions, cooperative housing is affordable -- not luxury -- housing.

Unlike the outright owner of a single family dwelling, the shareholders or members in a cooperative are each proportionally responsible for the physical maintenance and cost of operation of the entire building or complex, including all common areas.

The coop resident owns shares or a membership in the cooperative housing corporation, which owns the buildings. These shares entitle the member to occupy a given unit. In a housing cooperative, as in any cooperative, there is an identity between the shareholder/members of the corporation and the users of the corporation's assets. The corporation collects from each shareholder a monthly charge to cover operating costs (in the case of a housing cooperative, the cost of mortgage payments, taxes, maintenance, etc.).

Prudent management standards dictate that the housing cooperative make long range plans to provide for maintaining and eventually replacing its physical plant. Mortgage lenders or government regulators often require that a replacement reserve and a general operating reserve be maintained to assure the cooperative's ability to meet these needs over time.

Large scale maintenance and replacement projects (furnace replacement, parking lot repaving, asbestos abatement, and the like) require large scale financial investment. The necessary funds can, theoretically, be obtained in one of three ways:

The cooperative can assess the entire cost to its membership as and when the rehab work is done. The scale of the funding involved would place these assessments well beyond the means of many families, necessitating sale of memberships in a classic case of displacement.

The cooperative could borrow funds, increasing monthly charges to cover increased debt service. But, in many cases (particularly where government guaranteed or aided loans are involved), the first mortgage lender (or government guarantor) is reluctant to impair the security of its loan by allowing the cooperative to incur more debt. The option to borrow is also affected by the availability and cost of funds in the financial market. No cautious steward of property assumes that funds will be both available and affordable whenever need strikes.

The third option, the gradual accumulation of reserves over time, is an altogether practical and prudent way to meet future needs of the cooperative.

As monthly maintenance payments by the shareholders generate reserves, these funds are deposited in interest-bearing accounts. The interest earned further enhances the cooperative's ability to meet future replacement or operational needs. As you can see, reserves are an integral part of a sound overall program for operating and maintaining the cooperative over time. Yet the Internal Revenue Service has recently begun to treat reasonable reserves as if these funds were entirely unrelated to the cooperative.

Not only do we find this action by the I.R.S. disturbing and unreasonable, it is also unnecessary. Congress has long since recognized the nature of cooperatives and has set out a comprehensive program for their taxation, first enacted in 1951 and now embodied in Subchapter T of the Internal Revenue Code.

"Generally, the effect of the treatment specified (by Subchapter T) for patrons taken together with that also outlined (by Subchapter T) for cooperatives is to obtain a single current tax with respect to the income of the cooperative, either at the level of the cooperative or at the level of the patron."(S. Rep. No. 1881, 87th Cong., 2d Sess. 116 (1962))

Cooperatives are treated as essentially a zero-sum enterprise, where funds are collected from shareholder/members (patronage income) in amounts necessary to just cover the cost of business done with each member. If it turns out that costs are less than anticipated, Subchapter T recognizes and protects the mechanism (the patronage dividend) whereby the excess is returned to the patron in a retroactive price reduction. In a for-profit corporation, this income would be taxed twice, as net income of the corporation and as dividend income to the shareholder/member. In a cooperative, funds paid as patronage dividends are deductible in arriving at the cooperative's taxable income. To the extent that they represent business activity of the patron (and thus have provided deductions in arriving at the patron's taxable income), patronage dividends are taxable income to the patron.

> However, this rule will not apply in the case of patronage dividends paid with respect to purchases of personal, living, or family items. In such cases there is to be no inclusion in the income of the patron with respect to the patronage dividends even though they are not taken into account by the cooperative. This is in accord with the concept that patronage dividends represent price adjustments. Therefore, the patronage dividends in these cases represent downward price adjustments of personal, living, or family items and should no more lead to taxable income than bargain purchases of such items elsewhere. (S. Rep. No. 1881, 87th Cong., 2d Sess. 116 (1962))

To the extent that a cooperative operates as other than a zero-sum enterprise, Subchapter T treats it exactly as if it were a for-profit corporation. If patronage income is retained in excess of costs, it produces taxable income to the cooperative corporation and is taxed to the cooperative at a corporate rate. If non-patronage income is earned by the cooperative, it is included in the cooperative's income stream as well. Non-patronage income may be distributed to the cooperative's shareholder/members, but the dividend is not deductible in arriving at the cooperative's taxable income. If non-patronage income is distributed (rather than retained by the corporation), it is taxable to the distributee as well (it cannot, by definition, be a retroactive price reduction on a personal, living or family item).

A series of cases has confirmed the applicability of Subchapter T to housing cooperatives, and has spelled out the distinctions between patronage income -- income "integrally intertwined with the cooperative's functions" -- and non-patronage income subject to the significantly less favorable tax treatment I have just outlined (see, for example, Cotter and Co. v. U.S., 765 F2d 1102 (D.C. Cir. 1985)). By the reasoning of these cases, interest on reserves that are either demonstrably linked to the replacement and capital needs of a cooperative or demonstrably necessary as a hedge against forseeable operating contingencies MUST be treated and taxed as patronage (member-related) income.

The National Association of Housing Cooperatives asserts that the maintenance of reserves is a vital part of the sound management of our homes. When our reserves are prudently invested, they produce income. Naturally, this income is taxable. But, as Subchapter T clearly dictates, it is patronage income, taxable ONLY as part of our adjusted gross income along with the monthly maintenance charges paid by our members.

Reasonable reserves and the income that they produce are inextricably intertwined with the functioning of the cooperative. In fact, the Tax Court has held that the portion of monthly maintenance charges deposited into lender-held replacement reserves is a monthly contribution to capital by the shareholder/members, and is not to be included in the adjusted gross income of the housing cooperative (Park Place, Inc. v. Commissioner, 57 TC 767 (1972)). Yet, recently, as I have said, the Internal Revenue Service has attempted to treat these reserves and the interest their prudent investment creates as if they were independent business enterprises, totally unrelated to the business of the cooperatives whose continuance they insure.

There is patent unfairness in taxing these reserves as if they were a separate business, unrelated to the cooperative. A single family homeowner who is prudent enough to provide for such needs by setting up a separate savings account does not have to segregate this interest from all other income. That homeowner adds up all income, subtracts all deductions, and pays the taxes on the balance. In a cooperative, homeowners are being treated differently. The owner of a single family home currently pays a maximum of 28% tax on income. Cooperative homeowners can currently be taxed at a rate as high as 35% if interest income on coop reserves is separately taxed.

Likewise, in a for-profit corporation, the interest income generated by the investment of capital contributions or retained earnings is not segregated from the other business dealings of the corporation. There is no justification for treating a cooperative more onerously than either a single-family homeowner or a for-profit corporation.

If the Treasury Department is successful in its attempts to tax cooperatives in this manner, the results will be devastating. Cooperatives with reserves already inadequate to meet their physical and operational needs will find their resources further depleted. It will become impossible to make needed repairs. Income will be insufficient to meet operating costs if, for example, vacancies exceed projections or if unanticipated increases in property taxes or insurance or fuel costs occur. Delinquencies will surely occur, and a viable form of affordable home ownership will be most detrimentally affected. We must then forsee a reversal of all of the positive ripple effects that cooperative housing typically produces -- the pride of ownership that leads to stability and improvement of neighborhoods, all of this will doubtless be reversed.

SECTION 277

The justification advanced by I.R.S. in its attempts to tax my members' reserves as separate businesses is its claim that Section 277 of the Internal Revenue Code applies to housing (and other) cooperatives. NAHC is satisfied that it does not. Section 277 was enacted in 1969 to apply to non-exempt social clubs and membership organizations "operated to furnish goods or services to members." It requires that member income and expenses be separated from non-member income and expenses, taxing each separately. Section 277 speaks quite specifically to membership organizations such as country clubs, burial societies or mutual insurance societies, not to cooperatives.

Cooperatives are neither social clubs nor "membership organizations" as that term is usually understood. They are corporations formed to own and operate the assets their shareholder/members use.

Housing cooperatives do not provide "goods or services". The term of art used in the Internal Revenue Code to refer to real property is "facilities". The lack of any reference to "facilities" in Section 277 can only mean that that section was NOT intended to apply to housing "corporations operating on a cooperative basis", which are comprehensively treated under Subchapter T of the Code.

NO INFERENCE AS TO THE APPLICABILITY OF SECTION 277

Section 6 of H.R. 3663 makes direct reference to Section 277. NAHC requests that this reference be deleted and that a "no-inference clause" be inserted, allowing us the opportunity at some future time to seek judicial clarification that Section 277 of the Internal Revenue Code does not apply to cooperatives.

TAX TREATMENT OF REASONABLE RESERVES

Even if Section 277 is determined, at some future time, to apply to "corporations doing business on a cooperative basis" and the specific sub-group of those corporations which NAHC represents -- housing cooperatives defined as such by Section 216 of the Internal Revenue Code -- it does not follow that the test for non-member income under Section 277 differs in any respect from the test for patronage income under Subchapter T. As income which is "integrally intertwined with the cooperative's functions", interest on reasonable reserves should, in all fairness be treated as MEMBER income.

NAHC supports the idea of protecting cooperatives from especially onerous taxation in order to preserve them as providers of affordable housing. Many of our members would fall within the protected group as currently defined in the bill. But we are firmly united in our plea that H.R. 3663 be broadened to address the needs of ALL housing cooperatives, preserving affordable housing by defending us all from patently inequitable taxation. We ask your confirmation that interest on reserves that are demonstrably linked to the physical and operational requirements of a housing cooperative be treated as part and parcel of the cooperative enterprise.

TAX TREATMENT OF SUBSIDIES AND GRANTS

Similarly, Congress should make clear that the government subsidies and grants that make cooperative housing available to low and moderate income families is as "integrally intertwined with the operation of the corporation" as the maintenance charges paid directly by the cooperators. Traditionally, funds obtained through Section 8 and its predecessor programs were treated in this way. We wish to insure a continuation of this treatment, even if the subsidies come from non-federal sources.

A similar situation exists with respect to phantom arbitrage income produced and designed into the operation of certain state aided and financed cooperatives.

TAX TREATMENT OF INSURANCE PROCEEDS

At present the I.R.S. requires that insurance proceeds be reinvested in like property within a given time frame. Circumstances exist where housing cooperatives have been unable to meet this time requirement even though the funds will ultimately be used as intended. NAHC would like to see these funds treated as contributions to capital even when business exigencies prevent their immediate reinvestment. So long as these funds are irrevocably earmarked for capital improvements or replacements (by being prudently placed in a restricted reserve, for example), the purpose behind the arbitrary time limit will be well served.

80/20 THRESHOLD

Section 216 of the Code sets stringent requirements before a housing cooperative can pass on to its shareholder/members tax deductions for mortgage interest and real property taxes paid by the corporation. Failure to meet these requirements means the loss of this pass through to shareholders; in addition, outgoing members lose the opportunity to "roll over" their equity into another home without tax implications.

The 80/20 rule of Section 216 requires that 80% of the income of a cooperative housing corporation come from member sources. Section 5 of H.R. 3663 would waive this requirement totally in the case of limited equity housing cooperatives.

NAHC would prefer to see the 80/20 rule replaced by a "principal purpose test" applicable to ALL housing cooperatives. If the principal purpose of the cooperative is in fact to provide housing to its members, then it should qualify under Section 216. The present 80/20 standard is arbitrary and excessive. Principal purpose is, after all, the test generally applied by the Code to insure the bona fides of a taxable entity. If a more stringent standard is felt to be necessary, should housing cooperatives be forced to meet a higher threshold than the 60/40 standard applied to condominium associations by Section 528?

Everybody stands to benefit from a principal purpose criterion. Since non-member income is taxable income, under either Section 277 or Subchapter T, increasing the threshold of non-member income will remove present limits on rent that cooperatives may charge their commercial tenants. Taxes would increase accordingly. This revenue would more than offset any revenue loss that might be perceived to occur through clarifying the tax status of interest income on reserves.

COMMERCIAL INCOME OF LIMITED EQUITY COOPERATIVES

If Congress wishes to provide a special incentive to cooperatives which remain affordable by limiting the resale price of their memberships or shares, an important incentive can be provided through the tax treatment of commercial income. In New York, for example, mutual redevelopment cooperatives and those subsidized under the Mitchell-Lama program were purposely set up with commercial space to both provide a new location for businesses displaced by redevelopment and generate revenue to reduce the amount of subsidy that would be necessary to keep their housing affordable by low and moderate income families.

Limited equity cooperatives alone could be allowed to use commercial income to reduce member charges without adverse tax consequences (in much the same way exempt farmer cooperatives receive special benefits under Subchapter T). This should apply to newly created limited equity cooperatives as well as to existing ones.

DEFINITION OF LIMITED EQUITY HOUSING COOPERATIVE

H.R. 3663 refers to clauses (i) and (ii) of Section 143(k)-(9)(D) of the Code to define the term "limited equity cooperative". There are some circumstances where a bona fide limited equity coop may not precisely meet this standard. NAHC would like the language changed to include these cooperatives.

I thank you for the opportunity to share with you the views of the National Association of Housing Cooperatives. We appreciate the support and attention provided by this Subcommittee and its Chairman in addressing the critical needs of housing cooperatives so that they may remain an affordable source of owner occupied housing.

ADDITION TO STATEMENT OF TERRY LEWIS
PRESIDENT
NATIONAL ASSOCIATION OF HOUSING COOPERATIVES
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

March 10, 1988

We wish to further clarify and expand our suggestion regarding insurance proceeds discussed in our previously submitted written testimony. The suggestion deals with insurance proceeds received on account of the destruction of assets integrally related to providing housing by the housing cooperative (e.g. insurance proceeds received on account of the destruction of a boiler used to provide the cooperative with heat).

Our suggestion is that to the extent that such insurance proceeds are not considered contributions to capital and are included in income pursuant to other provisions of the Code such income should be classified as patronage/membership income. There are two reasons for our suggestion. First, the gain realized upon the receipt of such insurance proceeds would be determined with reference to the adjusted basis of the asset that was destroyed. The adjustments to basis would have been depreciation deductions which would themselves have been treated as a patronage/membership expense. It would be both illogical and unconscionable to change the characterization of the assets and their proceeds in midstream. Here again the underlying concept is the use of the integrally intertwined test applied under Subchapter T to determine appropriate tax treatment. Cases under Subchapter-T have held that gain from the desposition of assests integrally related to a cooperative's normal activities are to be considered patronage (membership) income. See e.g. St. Louis Bank for Cooperatives v. United States 80-2 USTC. par. 9509; Astoria Plywood v. United States 1979-1 USTC par. 9197

Chairman RANGEL. Mr. Rozet, chairman of the board, Associated Financial Corp.

STATEMENT OF A. BRUCE ROZET, CHAIRMAN OF THE BOARD, ASSOCIATED FINANCIAL CORP.

Mr. ROZET. Thank you, Mr. Chairman.

I am Bruce Rozet, chairman of Associated Financial Corporation. Our organization currently has over 50,000 low income housing units, most of which are under the HUD 236 and 221(d)(3) programs. These units are located in over 35 States, and they primarily serve low income families. Many of these properties are approaching the 20-year point when the mortgages are eligible for prepayment.

Our organization, perhaps uniquely, has been dedicated for many years to the concept of preservation. We started in this process back in 1975 when a HUD-formed task force funded by HUD, with PUSH in Chicago, focused on the problem of low income housing projects sponsored by church groups and community nonprofits that were deteriorating and going into foreclosure.

As a result of the reports of that task force, HUD enacted a nonprofit conversion program which utilized the Tax Code to bring in private investment to save literally thousands of nonprofit housing units from being lost to the housing stock. We participated in that program, and I believe that program saved the FHA insurance fund hundreds of millions of dollars.

During the Carter administration, Congress enacted a flex subsidy program designed to preserve existing housing. We worked with the administration at that time to make that program sensitive to the needs of low income housing projects, and we assisted in modifying the program to bring in private capital to supplement the flex subsidy funds available from the Government. As a result of that program and the Tax Code, thousands of additional units of low income housing were preserved and kept for low income families. More recently, the Government has begun to receive repayment of some of those flex subsidy loan funds.

In 1987, we assisted in preserving 3,000 units of low income housing by utilization of the recently enacted tax credit. Without the tax credit program, many of those units would have been converted to either condominiums, market rate housing, or been lost through deterioration.

The problem of preservation is not solely the problem of prepayment of HUD mortgages. It is equally and perhaps more the problem of deteriorating housing. When we lose a housing unit through deterioration, that is a lost housing unit. If we lose it because the rents rise above the level of affordability of the tenants, it is a lost housing unit.

We just heard testimony in New York that 3,000 housing units were lost under the Mitchell-Lama program in 1987. It would cost over $300 million to replace these units. It is our contention that preservation increases the stock of low income housing units, and it is sheer fiscal folly to build new housing while we are losing existing affordable housing at the same time. That principle has appeared in every form of housing legislation from the days of Senator Taft. Yet we have not followed that principle to place preservation ahead of new conversion.

In a period of scarce resources, it is our position that the low income housing tax credits, as well as any other forms of limited resources, should be highly targeted to first preserving what we have before we start on a course of building new housing at the cost of $100,000 or $125,000 a unit.

When we are losing housing, we are decreasing the stock of low income housing. When drugs run rampant in subsidized housing projects, it is losing housing. When owners do not have money to throw out the drug traffic in the District of Columbia, we are going to lose housing in the District of Columbia.

Therefore, the problem we face is preservation, and we see that as the main problem. The provisions in H.R. 3663, I think, would go a long way to helping in this cause. The housing and tax legislation of 1968 and 1969, was probably the last time Congress passed a coordinated housing and tax program. Part of that program included a tax provision known as the 1039 provision. It anticipated this 20-year prepayment problem we are facing today. Section 1039 provides that owners are permitted to sell their units to the tenants as co-ops or to a tenant formed non-profit, and they would pay no tax if they reinvested the proceeds of that sale in another low income housing project.

The reinvestment portion of section 1039 is no longer available as an option, but we do not see any reason why we should not follow through with what Congress intended in 1968 and 1969. The provisions of 3663, section 4, are essentially that solution. It allows existing owners to transfer the ownership of their property to tenant co-ops, to community nonprofit corporations, or perhaps to the State housing finance agencies without tax liability.

Since 1972 I have been directly involved in raising approximately a half a billion dollars of equity capital for low income housing from New York to California. I believe that if investors were given the option to have their projects transferred to State housing agencies or community non-profits, that an estimated half of the stock of 236's and 221(d)(3)'s projects would avail themselves of that option.

I do not see how this preservation option can result in a loss of revenue to the Government during the next 5 years. The owners will not sell those properties unless they can raise the rent to market levels and displace the tenants. This would eventually cost the Government significant amounts to provide alternative housing for displaced tenants. Transferring the properties to other owners such as State agencies, who would then be in a better position to retain them as low-income housing, would not cost the Government money. Investors would avail themselves of that opportunity, particularly if there is a sunset clause in this legislation.

Any owner not approaching the 20-year points for, say, 5 to 6 years who is given the opportunity in the next 2 or 3 years to make that choice, would be hard pressed not to elect the option to transfer ownership. It is that transfer of ownership that H.R. 3663 accomplishes, and I believe accomplishes very well for the benefit of public policy at very little cost.

I would like to comment very briefly on the tax credit program as it affects preservation. It requires approximately $4 of tax credit to build a new housing unit versus $1 of tax credit to preserve what already exists. And that is not counting additional forms of subsidy necessary to build new units. We, therefore, think the tax credit should be modified more for preservation purposes rather than for new construction purposes. With limited resources, we will get, as the Treasury said yesterday, more "bang for the buck," preserving housing than we will trying to build new housing.

I have encompassed many of these recommendations in this report which I have submitted for the record. Thank you, Mr. Chairman.

Chairman RANGEL. Thank you.

[The statement of Mr. Rozet follows:]

STATEMENT OF A. BRUCE ROZET, CHAIRMAN OF THE BOARD, ASSOCIATED FINANCIAL CORPORATION

Mr. Chairman, Members of the Committee. My name is Bruce Rozet. I am the Chairman of the Board and C.E.O. of Associated Financial Corporation. Thank you for inviting me to address the problems of maintaining the stock of governmentally assisted low income housing and to discuss the role which the tax code should play in preserving that housing.

PAST PRESERVATION PROGRAMS RELIED ON IN THE TAX CODE

Let me, first, qualify my testimony by briefly describing the role my Organization has played in relation to low income housing. For over fifteen years, we have attracted private capital to meet the needs of government assisted housing. From 1971-1975 we specialized in providing private equity capital for the development and rehabilitation of inner city housing - from the South Bronx and Harlem in New York to Watts and the Tenderloin in California. From 1975 until the present we have specialized in providing private capital to preserve existing housing on a nationwide basis. In 1975, I served on a HUD appointed special task force with Reverend Jesse Jackson to develop methods for obtaining private capital to assist existing non-profit housing projects that were deteriorating and facing foreclosure. We created the non-profit conversion program which saved thousands of low income housing units from foreclosure by providing millions of dollars of private capital for rehabilitation and debt service. In the process, the FHA insurance fund saved hundreds of millions of dollars.

Provisions in the tax code combined with Congressional housing policy made this preservation effort possible. Concurrent with this effort, we recommended the modifying of regulations governing the Flexible Subsidy program to attract matching private capital, thereby permitting the appropriated funds to be leveraged to preserve more housing units. The tax code was vital to this process. In the late seventies' we assisted HUD in the expansion, redefinition and streamlining of the HUD's Transfer of Physical Assets program, thereby attracting millions of dollars of new private capital to preserve thousands of additional low income housing units, restoring them to safe and sound physical and financial condition. Again, the tax code was a vital ingredient. In 1987, through the use of the newly created Low Income Housing Tax Credit program, we were able to provide millions of dollars to assist in the preservation of over 3,000 low income housing units. Without the tax credit, much of this housing would have been lost due to deterioration or conversion to market use. The tax code was, and will continue to be critical to this housing preservation.

Since 1975, we have been one of the few private groups in the country totally concerned with the preservation of existing governmentally assisted low income housing. Today, we have the responsibility for overseeing approximately 350 housing projects consisting of 50,000 residential units in more that 35 states.

Our experience of the past fifteen years convinces us that the preservation of existing low income housing should be the cornerstone of National Housing Policy, and that the tax code elements that support that Policy must be heavily oriented to preservation efforts. Good housing policy must be supported by good tax policy.

The tax code has been a major factor in the development of most of the existing inventory of governmentally assisted housing for the past twenty years. Congress coordinated Housing and Tax Policy in legislation passed in 1968 and 1969 to stimulate the construction of the current housing stock. In 1968, the Congress and the Administration agreed on a national housing policy to significantly increase the supply of new and rehabilitated low and moderate income housing, and enacted the enabling which has been the basis of all housing policy for the past twenty years. The '68/'69 legislation was the last major effort at comprehensive, coordinated tax and housing legislation.

The role that the tax code should play in housing policy can only be assessed by first defining housing objectives and then evaluating the effectiveness of various methods of meeting the objectives - be it loans, grants, subsidies and/or tax incentives. The existing housing stock, however, is inextricably tied into the tax code and any program aimed at the preservation of that housing must rely, in part, on modifications in tax law to be effective.

THE IMPORTANCE OF MODIFICATION OF THE 1039 PROVISIONS OF THE TAX CODE AS PROPOSED IN H.R. 3663

Most existing governmentally assisted housing is owned by private investors. They derive little or no current economic benefit from ownership of this property. Most of their ongoing tax benefits were legislatively cut short by the 1986 Tax Act, and cash flow from operations is insignificant. However, these owners have an overhanging tax liability based on the tax benefits they have enjoyed in the past. They would have to sell the property for approximately two and a half times their original investment just to recover their original investment and pay the tax due on the sale.

Present owners are therefore confronted with two options. Retain the property without investing additional capital and hope the property will not deteriorate, or upgrade the property, raise the rents eventually to full market and/or convert to condominiums. In either case, the tenants, local communities and the Federal Government are the losers. Low income housing resources will be lost and the burden shifted to the Federal Government to replace the lost housing at four to five times the cost of the existing stock.

In fact, during the last ten years, the country has lost much more low an moderate income housing through deterioration and marketizing than we have built. Preservation policies and incentives must therefore serve both to arrest the deterioration of existing housing as well as to discourage rental increases to full market level, or conversion to market housing. A successful preservation program will not only prevent wide spread displacement of low an moderate income tenants, but will result in an increase in the supply of affordable housing.

Owners, however, must be given adequate economic incentives to preserve housing for continued low income use. The incentives must be designed to encourage owners to either 1) repair and rehabilitate their properties and commit them for continued use as originally determined under the applicable government assisted programs, or 2) transfer the ownership of the properties to new owners who will agree to their preservation, or 3) convert to tenant ownership.

H.R. 3663 is a soundly conceived first step in modifying provisions of the tax code to meet preservation objectives. Section 4 "Exclusion of Gain from Disposition of Use Restricted Qualified Low-Income Housing Project" is an extension and modification of the intent of Congress in the '68/'69 housing and tax legislation.

The original legislation that created the incentives to attract private capital to build this housing anticipated the problem of early prepayment. That legislation created an exit program for some of the owners through Section 1039, whereby the owners could convey the property to a suitable non-profit or .pa tenant group and reinvest the proceeds in another project, thereby allowing the basis in the old property to carry over to the new. Unfortunately, such reinvestment opportunities are virtually extinct so that option has become of questionable value.

Reestablishing this incentive is one method for preserving some of the low income housing stock that might otherwise be lost in the next five to seven years. H.R. 3663 will provide a positive incentive to existing owners of low income housing projects to opt for selling them to new entities committed to their maintenance as affordable housing.

From the point of view of many passive owners of HUD properties, the uncertainty of the overhanging tax liability is cause enough to accept an opportunity to sell the property to a new entity substantially below market value - often for the mere assumption of the debt. The very passive, uninvolved position of most investors will move them to accept a know result and the elimination of pending future liability versus the uncertain result of being able to marketize their property to sell at a profit.

It is reasonable to assume that almost half of the HUD projects owned by limited partnerships would accept this options, particularly if the legislation carried a "sunset" provision of three years from date of enactment. Project owners who have five or more years remaining on their low income use restrictions would be sorely pressed to act now versus waiting for five or more years to determine market conditions favorable for increasing rents and refinancing with relatively insignificant current tax benefits. A significant segment of the HUD stock would move to new owning entities of the type envisioned in H.R. 3663.

There should be no reduction in current tax revenue to the government, particularly in the next five years. Under present conditions existing owners of qualified projects will not sell their properties and incur a tax liability. They will retain ownership of the properties and either allow them to deteriorate, or attempt to raise rents in anticipation of conversion to market rents or condominiums. In either case, the government will receive no additional revenue, but could lose as many as 500,000 low income units from the national housing stock over the next ten years. The cost of replacing these units or otherwise subsidizing the affected families could eventually cost the government $25 billion.

In fact, it could be suggested that the Treasury would gain revenue in the near term five year period since owners exercising the option of a revised Section 1039 sale would be foregoing additional passive losses which might be offsetting some of their passive income or accruing unused passive income to eventually offset the taxable effect of a future more profitable sale. This proposed legislation should clearly have no negative budget effect.

The proposed legislation recognizes several type of prospective qualified purchasers, each meeting certain prescribed circumstances which might prevail in the housing inventory as a whole. The overriding consideration must be a clear binding obligation to maintain the property for defined levels of low income housing use. A secondary qualifying element for effecting this type of transaction is movement in the direction of achieving ownership of the property by the tenants themselves. This objective was apparent as national housing policy in the 1969 legislation, but is even more valid today. If, through a new defined national housing policy, we can enact the necessary enabling legislation to bring about large scale ownership of housing by the tenants - with clear enforceable requirements for continued maintenance of the housing at affordable levels, we will have completed the logical social and economic cycle of placing control of the housing directly in the hands of those with the largest interest in its preservation.

However, the direct step to tenant ownership may not be realizable today. Existing tenants, for the most part, are not organized and trained to assume the burdens of ownership. Many of the properties are older and need capital infusions for maintenance and upgrading. Suitable financing mechanisms and enabling cooperative legislation, both local and national, need study and revision. By qualifying prospective buyers as private partnerships willing to provide the capital and management resources and/or community non-profit housing corporations with resources to meet property and tenant needs, a transitional condition if created whereby we can facilitate the movement of property from the ownership by existing investors who are not committed to preservation for low income use, to new ownership with a clear mandate and obligation to preserve the property as affordable housing. The new resources provided by these new, qualified owning entities will further assure property preservation and move in the direction of tenant control.

COMBINED FINANCING AND TAX INCENTIVE TOOLS FOR PRESERVING ENDANGERED PROJECTS

Certainly, all owners will not elect to take advantage of a modified Section 1039 provision. This will be particularly true of owners of property very favorably located in high median income areas where the prospect of eliminating the low income tenant restrictions and bringing the properties to market rents or converting to condominiums or cooperatives is a very real and present prospect. It may not be possible to intercept all of these flights from the inventory, but we might achieve an effective compromise in at least many of these serious and volatile situations.

The 1987 Housing Act recognizes the importance of low income housing preservation and in particular the threat of prepayment of projects reaching their twentieth anniversary. Among other tools provided in that legislation is a modified form of insured second mortgage financing designed to enable owners to borrow funds for rehabilitation and recover a portion of their equity in return for committing to retain the property as low and moderate income housing. This financing program is ideally suited for properties that could be sold or marketed conventionally because of location and special market conditions. This financing program could be significantly enhanced if it were administered by the State Housing Finance Agencies in conjunction with the use of tax free bonds. The resultant FHA insured financing would reduce the interest rate on the mortgage, reducing rents and risks and providing for closer local involvement and monitoring. The limited use of tax free financing by State Agencies for preservation purposes would be consistent with the administration of the tax credit program and would bring additional resources to the preservation efforts.

Most of these agencies are presently less active in financing new construction. By directing their attention to preservation, they could become an important and efficient source of assistance in increasing their state's supply of low income housing. By permitting states to issues tax free bonds outside of the volume cap and exempt from alternative minimum tax, a most valuable financing tool would be available for housing preservation. Combining State Housing Finance Agency capability and the limited use of tax free bonds for preservation purposes would facilitate rehabilitation, transfer of ownership to local non-profit groups and conversion to tenant ownership. The limited amounts of such financing would keep the revenue costs small, and would substantially increase preservation results.

COMPARING THE RESULTS OF SELLING AT MARKET VALUE VERSUS UTILIZING PROPOSED INCENTIVES TO PRESERVE LOW INCOME HOUSING

To illustrate the effect of various incentives and options, I have taken a specific, real project facing the prospect of mortgage prepayment within one year. The project consists of 200 units and is located in an affluent middle class community. The local government has recognized the importance of retaining this property as affordable low to moderate income housing for the community. The property currently has $2,000,000 221 D-3 mortgage and was built in 1969.

Option 1. The owners have had offers to sell the property for $10,000,000 to a buyer who intends paying off the HUD mortgage, improving the property and eventually converting to condominiums.

This option would net the present owners approximately $5,400,000 after payment of the HUD mortgage and their tax obligations.

Option 2. The owners might obtain an FHA 241 second mortgage consistent with the recent revisions in the 1987 Housing Act. This loan could be financed by the sale of tax free bonds with interest at 8%. The existing HUD mortgage and its regulatory agreement would remain intact. From the loan proceeds, $1,000,000 is allocated to repairs and rehabilitation and $500,000 is retained as a working capital reserve. Rents are increased annually to cover increased debt service but never could exceed 80% of area median income with tenants paying a maximum of 30% of their income in rent. The property is committed to this occupancy status for twenty years.

The owners net approximately $5,250,000 under this option.

Option 3. The owners convert the property to a tenant owned Cooperative. The price is established based on tenant/buyer income averaging 70% of median income for the area with monthly costs to the tenants not to exceed 30% of their income. The HUD mortgage is assumed by the Cooperative and new secondary financing resulting from tax free bond sale proceeds is used to provide payments to sellers as well as $2,000,000 for repairs, upgrading and working capital.

Assuming the owners paid taxes only on the cash received and were not taxed on their negative capital account pursuant to H.R. 3663, the owners would net approximately $5,000,000 after tax.

In summary, comparing the three options and recognizing that this property is a prime example of one whose market value has risen dramatically, it is clear that the owners could readily be persuaded to adopt Options 2 or 3, which would serve to retain the property as low cost housing, as an equally viable alternative to marketizing.

LOW INCOME TAX CREDIT MODIFICATION TO FINANCE PRESERVATION OBJECTIVE

The use of the new low income housing tax credit is a valuable tool for long term housing preservation, but some important changes in orientation are needed. The tax credit, as embodied in the 1986 legislation, provides higher tax credit for certain categories of new construction and penalizes acquisition of existing housing and housing financed with certain tax advantaged or government assisted financing. If preservation is truly accepted as a national housing objective, then some provisions of the tax credit program should be revised. After one year of operation, it is apparent that the tax credit is difficult to use for new construction without large amounts of other forms of subsidies or grants, thereby substantially increasing the cost to the government. In most cases, it requires almost four times as much tax credit to produce one conventionally financed new housing unit as it required to preserve and moderately rehabilitate one existing unit. In effect, we can preserve almost four times the number of units of housing if we direct the tax credit to preservation.

A number of important modification of the tax credit law could significantly enhance the preservation effort.

1) Increase the tax credit that can be taken on existing units from 4% to 6%. This will increase the ability of new buying entities to acquire some of the better properties for preservation and/or make it possible to expend more on physical improvements. This higher tax credit could be coupled with a requirement that the project be maintained as low income for the balance of the life of the mortgage or a minimum of twenty years (rather than the fifteen years required under the 1986 legislation).

2) Change the unit by unit test for tenants at 60% of median income to a threshold test of 60% of the tenants at 60% of median to qualify all of the units in the project as eligible for tax credits. This modification will have a number of benefits for preservation efforts. First, many of the existing projects that should be preserved have tenant income units over a broader income range - perhaps 40% - 90% of area median incomes. Secondly, a broader income range makes the total project more economically viable by permitting rents to be set on a variable schedule so that all tenants pay only 30% of their income in rent. Third, requiring all units to be occupied by tenants at 60% of median to qualify for tax credit will cause displacement of tenants at 60% - 90% of median income levels and in effect return us to repeating one of the mistakes of the past - concentrating all of the low income families in the same projects. This works against sound preservation concepts which is enhanced by greater economic integration.

3) Waive the ten year requirement for low income tax credit if it is determined that it will serve preservation objectives. Sec. 3 of H.R. 3663 provides for this waiver but it should be coupled with a commitment for longer term low income use - the balance of the mortgage or a minimum of twenty years. This commitment should take the form of a legally binding regulatory agreement, not merely a recapture of tax benefits plus penalty.

4) Permit a waiver of any recapture of tax credit benefits for owners who cause the property to be converted to tenant ownership under an appropriate government approved conversion plan assuring its continued low to moderate income status. Such a plan should involve adequate funding by the owners prior to conversion to assist the tenants in the formation of a suitable type of cooperative owning entity, training of the tenants in responsibilities and obligations of ownership, and sufficient working capital to meet initial needs of the new tenant owners.

5) Over the next several years a number of low income projects will require new capital for repairs and rehabilitation to permit the projects to continue to meet low income housing .pa needs. Existing investors may be unwilling or unable to contribute the necessary capital. Their only options would be to

sell the property to new owners requiring extensive utilization of tax credits to justify the purchase by a buyer or allow the property to deteriorate and be lost from the housing stock.

A modification to the 1986 Tax Act should be made permitting the partnership to admit new investors who will supply the capital needed for rehabilitation, and who, in turn, will be allocated all of the tax credits applicable to the rehabilitation expenditures. In effect, the existing partnership continues to own the property, the newly admitted investors provide the needed capital and receive the attendant tax credit benefit, and the property is rehabilitated at at lesser total tax credit cost to the government that if it had to be sold to new owners (who would be entitled to additional tax credits on the building acquisition).

Section 42 provides no guidance as to whether the low income housing credit may be specially allocated to those partners who funded the expenditures giving rise to the credit. Under the section 704(b) regulations, it appears that the credit must be allocated on a basis consistent with the allocation of the partnership's depreciation deductions. Regulations should permit a partnership, at its election, to allocate credits on a basis that is reasonably related to the funding of the expenditures which gave rise to the credit.

CONCLUSION

In conclusion, our ability to preserve our existing governmentally assisted housing stock will be critically impaired unless Congress provides a coordinated program of Housing and Tax legislation designed to meet preservation objectives. H.R. 3663 is one excellent step in that direction. We urge consideration of the other programs proposed to assure the nation against the loss at this irreplaceable housing inventory.

Chairman **Rangel**. Thank you, Mr. Rozet.
Mr. Zigas.

STATEMENT OF BARRY ZIGAS, PRESIDENT, NATIONAL LOW INCOME HOUSING COALITION

Mr. **Zigas**. Mr. Chairman, thank you very much for the opportunity to testify today. I appreciate the interest you and the full committee have shown in the progress of the tax credit and the use of tax policy for preserving existing housing.

My name is Barry Zigas. I'm president of the National Low Income Housing Coalition, a national nonprofit organization based here in Washington, representing the interests of low-income housing consumers and nonprofit developers and owners of housing.

I'd like to cover briefly three points that are more extensively discussed in my written statement.

First, the extent of the low-income housing crisis which leads us to have legislation to try to address these needs.

Second, some specific comments on H.R. 3663; and, finally, some comments on the need for continuing refinement and development of the low-income housing tax credit passed here in 1986.

First, I think it's important to emphasize over and over again how fundamental a crisis low-income people face in finding and maintaining affordable housing.

In 1983, the Census Bureau estimated there were 8.5 million renter households whose incomes were below $7,000 a year, over half of whom paid more than half their income for rent.

Since 1974, according to new figures developed by the Joint Center for Housing at Harvard, real rents in assisted housing and regular housing, using 1986 dollars rose by 14 percent, while incomes among single female-headed households, for instance, declined by 35 percent.

These same declines, particularly among lower income households are evident across the board. The result of these trends is a terrible crunch between poor people's ability to pay for housing and the actual cost of housing in the marketplace. And this problem is likely to be exacerbated if Congress does not act to prevent the potential loss of thousands of units of currently HUD assisted housing that is owned in the private sector.

My testimony reviews some of the figures that have been provided by GAO and CBO. I think it's important simply to point out that the Congressional Budget Office has estimated that over 300,000 units of currently assisted housing will become eligible to prepay their mortgages, as Mr. Rozet and other witnesses have explained. And if they choose to do so, it will be in order to change the use of the property and will lead to the displacement of low and moderate income people.

If we're concerned about the homeless crisis we face today, I would suggest that failure to act to prevent this displacement will only lead to a much more acute homeless crisis in those jurisdictions least able to provide alternative housing.

Specifically are my concerns relating to H.R. 3663. I commend you and Mr. Frank for introducing this legislation for moving forward an agenda to use the code to try to preserve the existing supply of housing.

I have a few specific concerns I would like to share with you.

First, I agree with the testimony from the GAO this morning. I believe the proposed characteristics which would identify so-called qualified low-income properties are far too broad. If my interpretation of the requirements is correct, the committee must act to target these subsidies much more tightly.

Requiring simply that 20 percent of the tenants, is actually the way the legislation reads, be subject to some form of rent restriction or income restriction, really allows an enormous amount of potential abuse in the use of this measure. And I would urge this committee to focus this measure on property which predominantly serves low and moderate income people.

Also, just a technical matter, when you refer to 20 percent of the tenants as opposed to 20 percent of the units, it leaves some question as to exactly what the intent is. But whatever the unit you use only requiring 20 percent to be restricted in some undefined way is entirely too little direction.

I believe the law should include an absolute preference for transfers to nonprofits and tenant organizations, for them not simply to be treated as an equal with a for-profit entities which choose to buy the property. But that there would have to be an effort made, first and foremost, to transfer these properties into the nonprofit or public sectors so that we don't come back here in another 15 years and have the same discussion about what to do the next time the owners are faced with an opportunity to prepay.

There are some other specific recommendations—I don't want to exceed my time here—that are outlined specifically in my testimony.

One final thing I would highlight is the legislation that you've proposed focuses entirely on incentives to owners, to induce certain kinds of behavior. And the same is true of title II of the 1987 Housing Act, which also addressed this issue.

I would urge this committee to seriously consider the need to enact certain disincentives for sale out of low-income use as well. One possible way to do this would be to impose some form of a windfall profit tax on owners who do not choose to take advantage of incentives but, instead, sell their properties out from under the assisted inventory. This would serve two purposes, one of which would be to discourage owners from taking this step by discounting the ultimate value to them of the property once it's sold.

The second is that it would provide HUD a source of revenue with which they could continue to subsidize and improve those housing units which remain in the stock.

HUD has been asked repeatedly over the last 20 years in these projects to move forward every time owners faced problems they could not overcome and still serve low-income people, and HUD and Congress have generously increased subsidies to these project where necessary.

The Government should not just be a foul weather friend, but where it's made these investments has a right and a responsibility, I believe, to seek some portion of whatever benefits might accrue for a sale out of an assisted stock.

Finally, a few brief comments on the low-income housing tax credit. We are very pleased and proud that Congress enacted this credit. We were very integrally involved with its development.

We think that the credit's history in this last year has proven that it can be made to work, but there are several important changes that must be made in order to make it work well.

First, we support the passage of the technical corrections which your committee did approve last year, and which got lost in the last minute Reconciliation Act. We think it's very important to pass those technical corrections as soon as possible.

Second, we believe it's important to address the questions that your legislation raises about the 10 year placed in service rule. And this is particularly true for HUD foreclosed properties that are now in the HUD inventory. It is our understanding that Treasury's interpretation of the 10 year rule is not being used to restart the clock after HUD forecloses on a property, in other words, to cleanse it of prior transfers, and may disqualify properties that HUD is trying to sell out of its inventory on the basis that someone else had placed it in service less than 10 years before. Now, this is a tremendous obstacle to the transfer of these HUD properties back into the private sector where they can continue to serve low-income people.

We would like to urge you to consider making the tax credit refundable. One of the obstacles nonprofit organizations repeatedly raise with us is that they are reluctant to participate in the credit because it requires them to transfer ownership interest in their properties to for-profit investors, whose interest at the end of the compliance period may not be the same as that of the nonprofit sponsor.

We could eliminate this problem in a hurry by making the credit refundable and allowing nonprofit organizations to take direct advantage of it. An alternative would be to allow the credit to be transferrable, again to just eliminate the requirement to transfer an ownership interest which creates these conflicts at the end of the period by requiring ownership to be transferred.

Finally, we should, at the very minimum, provide in the legislation a means by which investors and sponsors of these properties can agree at the front end on a disposition of the property into the nonprofit or social housing sector as a condition of entering into the agreement. This would enable investors and sponsors to agree at the front end without having to worry at the end of 15 years what happens to the property.

I've suggested these in what I think are a declining order of ideality for me. But any of them would help.

A final limitation—I know I'm over my time, I'll make one more point—that I think it's critical that this committee address is the current reasoning that I understand Treasury is taking with respect to whether tax credit properties can be developed for use by disabled tenants or the homeless, to take two examples of special populations.

As you know, the conference report and the blue book discussed the intent for tax credits to be available to the general public. And it's our understanding that this is being used by Treasury to justify not allowing credits to be used in properties which are designed specifically to provide housing for disabled people or for the homeless, inasmuch as they're saying, well, that's not the general public. That's clearly not the intent of the Congress. You permitted SRO units to be allowed. I think it's important for this committee and the Congress to emphasize that as long as practices in renting are nondiscriminatory and do not restrict to certain groups, that building housing for special populations is an entirely appropriate use for the credit as long as the populations meet the low-income requirements.

Thank you for the opportunity to testify, and I'll be happy to answer any questions you may have.

[The statement of Mr. Zigas follows:]

STATEMENT OF BARRY ZIGAS, PRESIDENT, NATIONAL LOW INCOME HOUSING COALITION

Mr. Chairman, distinguished members of the Subcommittee, my name is Barry Zigas. I am President of the National Low Income Housing Coalition, a national nonprofit, nonpartisan membership organization which provides advocacy services for improved and adequate federal assistance to end the low income housing crisis. I appreciate the opportunity to appear before you today to share our views on the low income housing tax credit and on H.R. 3663, which would provide additional tax incentives designed to assist in the preservation of existing HUD-assisted housing.

I would like to cover several areas in my prepared remarks this morning. First, I would like to review the facts concerning the low income housing crisis and especially the threat of displacement and homelessness caused by potential prepayments by current owners of projects with federally assisted mortgages. Second, I would like to address the specifics of H.R. 3663, as requested in your invitation to testify today, and make some suggestions for improvements which I hope the Committee will consider. Finally, I would like to make some observations and comments on the overall effectiveness of the low income housing tax credit, and include brief recommendations for changes in that program to enhance its usefulness.

THE LOW INCOME HOUSING CRISIS

Low income people face an unprecedented housing crisis. A principal cause of homelessness is the severe lack of affordable housing for low income families.

The 1983 Annual Housing Survey conducted by the Census Bureau for HUD found that 8.4 million renter households earned less than $7,000, or a little more than 50 percent of the renter median income of $12,900. Over half of these households paid more than 60 percent of their income for rent.

Among renters with incomes below $3,000 per year, the shortage of affordable housing is even more acute. A total of 86 percent of these 2.2 million households paid more than 60 percent of their income for rent in 1983.

These are the very lowest income tenants in America. Yet they are paying the highest rent burdens of any income group, either among owners or renters. And since 1970, their plight has worsened.

America has experienced an unprecedented loss of affordable housing stock during the decade of the 1970's. In 1970, there were almost 15 million housing units affordable to a household earning $5,000 or less a year. By 1980 this number had dwindled to less than 3 million. The number of renter households with incomes of $5,000 or less also shrank during this period, but only to about 6 million, leaving half as many units as families.

In the last five years, this loss of affordable housing in the private sector has been coupled with a nearly 60 percent reduction in federal housing assistance funds. Moreover, almost the entire focus of federal housing assistance is now placed on subsidizing rents in existing housing. There are virtually no funds for the production or rehabilitation of affordable rental housing. This is the principal reason why the tax-based incentives for production and preservation remain so important.

The Prepayment Threat

Based on information gathered by the General Accounting Office (GAO) and the CBO, thousands of low income families are at risk of becoming homeless because of privately owned housing disappearing from the federally assisted inventory:

- As of April, 1986, 6,664 HUD-assisted units assisted under the Section 221(d)(3) insurance program were eligible for prepayment of their mortgages.

- By the end of 1987, another 3,796 units will become ripe for unrestricted mortgage prepayments.
- In 1987 alone, Section 8 rental subsidy contracts covering 76,419 housing units will expire. Owners of these units have the right to renew their contract for an additional five years, or to cancel their participation in the Section 8 program and rent the units at market rates without government assistance.
- Between 1985 and 1986, Section 8 rental subsidy contracts for 45,875 units expired, and owners were offered the opportunity to either renew or opt out of the program.
- In 1988, an additional 150,488 Section 8 units could be lost to the affordable housing supply if the owners do not elect to renew.

Altogether, between 1985 and 1988, 272,782 units of housing assisted under the Section 8 program alone may be lost because of potential contract cancellations by private owners.

In contrast, the entire HUD FY88 budget will provide only 77,000 additional units of low income housing assistance. Again, nearly all of these new subsidies will be provided for existing housing units in for which tenants will receive either vouchers or Section 8 Certificates.

The Homelessness Threat

If these displacements take place, the tenants will have few options. The median income of all tenants in public housing and Section 8 units was just over $6,000 per year in 1983, according to the U.S. Census Bureau. This was about one-third of the national median household income in the same year.

These households are among the "privileged few" very low income renter households by dint of their participation in the federal assistance programs. Section 8 and public housing tenants pay no more than 30 percent of their adjusted income. Tenants in privately owned housing subsidized through the National Housing Act programs (Sec. 221(d)(3), Sec. 236) pay rents which are reduced to reflect the owner's lower interest rate, and rents in these properties are regulated by HUD.

In the general rental market, at least half the renter families with incomes at this level pay more than half their income for rent.

For increasing numbers of families, the consequence of these dry statistics is homelessness. Faced with intolerable rent burdens, families increasingly find themselves "falling out" of the housing market altogether. Overcrowding among low income renters sharing inadequate housing contributes to an even larger and largely undocumented problem of "hidden homelessness".

Invaluable Stock

Although federal housing assistance programs have often been derided as failures, the fact is that they have succeeded to a remarkable degree in providing a supply of housing which is affordable to very low income households. More importantly, they are increasingly the only supply of housing which is affordable to these households.

According to research carried out by Cushing N. Dolbeare for the National Low Income Housing Coalition, federally assisted housing accounts for 67 percent of all units renting for less than $100 per month; 44 percent of all units renting between $100 and $149 per month;

and 21 percent of all units renting for between $150 and $199 per month. An affordable rent at 30 percent of gross income for a family earning $8,000 per year is $200. For a family earning $7,000 per year, the affordable rent is only $175 per month. There are over 8 million renter households with incomes below $7,000 per year, and the Joint Center for Housing at Harvard University recently estimated that there are nearly 12 million renter households with annual incomes below $10,000.

Federally-assisted housing thus represents a very large share of the housing which very low income households can afford.

As noted earlier, however, hundreds of thousands of units of federally assisted housing which is privately owned may be lost from this inventory if action is not taken quickly. Among the roughly 600,000 units assisted under Section 236 and Section 221(d)(3), the Congressional Budget Office estimates that nearly one-half will be eligible to prepay their mortgages without prior HUD approval and change the use of the properties as a result.

Yet these properties provide affordable housing to low and moderate income tenants at an average federal subsidy of $1,185 per year. The cost of replacing these units is nearly incalculable. Even if the tenants are given vouchers or Section 8 Housing Certificates, the likely cost to the federal government will rise to over $5,000 per year, according to HUD's latest budget estimates. Moreover, in those markets where prepayments are most likely to occur, tenants are least likely to be able to find housing in which they can take advantage of income based subsidies like Section 8. The supply of housing is too tight, and affordable units too scarce. It is this high demand for low supply which is luring owners out of the federal assistance programs in the first place.

Congress has already enacted Title II of the Housing and Community Development Act of 1987, signed by President Reagan on February 5, which provides direct relief to prevent the loss of these units. This new title prevents owners from prepaying their mortgages without prior HUD approval. It authorizes HUD to offer owners new incentives to increase their returns from existing subsidized properties in return for owners' agreement to maintain the low income restrictions on the property for the remaining life of the mortgage. These new restrictions are good, although limited. Most importantly, they will expire at the end of 1989, and Congress will have to revisit this issue again early next year.

The provisions in H.R. 3663 are a commendable effort to provide tax-based relief to encourage owners to continue the low income use restrictions which are on the property by stimulating sales to either nonprofits, tenant organizations, or other profit-motivated buyers who will agree to maintain the restrictions. These provisions are not new. Similar provisions were enacted at the beginning of the mortgage subsidy programs which are now jeopardized. They were designed to encourage the same sorts of transfers under the old programs, with the requirement that proceeds would be used to develop additional units of housing assisted under the same or similar programs. Today, of course, there are no similar programs. The changes proposed in this legislation recognize this change in circumstance, and offer similar relief in this new environment.

I would recommend some changes to the proposals which I believe will improve them.

1. **The proposed characteristics which would identify "qualified low income properties" are far too broad. If my interpretation of the proposed requirements is correct, the Committee must act to target the proposed tax-based subsidies much more tightly.**

   The current proposal would appear to qualify properties in which at least 20 percent of the units are subject to rent or income restrictions. This would qualify thousands of properties which were financed under the inadequate targeting requirements of the pre-1986 tax Code for tax-exempt bonds. If I read the proposal correctly, owners would receive forgiveness of their capital gains liabilities for the entire property, 80 percent of which might well be rented to higher income tenants at market rents, simply on the basis of the 20 percent of the units which provide some affordability. This is much too generous an interpretation. It is important to recall that prior to 1986, investors in rental housing received very generous depreciation benefits. Some adventurous investors and their counsels even qualified properties with only 20 percent of the units set aside for low income tenants for the most favorable, 15-year depreciation benefits made available under ERTA. Allowing these new tax subsidies in return for only some continued restrictions on such a small percentage of the units is not defensible.

This section does not specify what sorts of restrictions must apply to the units or tenants in order to qualify for the relief. Would a restriction that limited occupancy to tenants with incomes below 150 percent of area median qualify? Would 80 percent of median? Would a rent ceiling of 50 percent of 100 percent of area median income qualify the project for favorable treatment? Would New York City's rent control laws qualify all the units in properties located there? I believe the intent of the drafters was to require that relief be offered to stimulate the sale of properties which were principally serving low and moderate income tenants. The current language does not go far enough in defining who these tenants are or what conditions the new owners must preserve.

Another concern with the current language is the requirement that owners need only demonstrate that they have owned the property for the last 5 years. I assume this is designed to qualify owners who purchased properties and received ERTA benefits and are now facing a phase-out of passive loss benefits because of the 1986 Tax Act. This may be too lenient a standard on which to base a new tax subsidy.

Finally, the same sections actually state that restrictions need only apply to "at least 20 percent of the tenants" (emphasis added). Whatever the intent, this could be read to mean that less than 20 percent of the units need to be covered by restrictions, if the units in question happen to include 20 percent of the individual tenants in the property. This section needs to be clarified.

New tax incentives should be made available first and foremost to stimulate the preservation of housing projects which principally serve low income people. There may be a justification for offering capital gains relief on a portion of the disposition if only a portion of the units are actually restricted or serving low income persons. The current requirements for this treatment under Section 1039 specifically enumerate the federal housing assistance programs which qualify for the intended relief. Although some counsels have qualified properties assisted through tax-exempt financing for treatment which was intended to be reserved for such enumerated properties, the Committee need not leave this loophole open when offering new incentives.

2. **The law should provide an absolute preference for transfers to either nonprofit organizations or tenant cooperatives.**

As currently written, H.R. 3663 treats all potential buyers equally, if they are prepared to retain the low income use restrictions. This accomplishes one goal, which is the short-term preservation of the units. But it does not address another goal, which I believe should be given equal weight, and that is the goal of removing these units as much as possible from the speculative real estate market. We are currently grappling with the potential loss of hundreds of thousands of low income housing units because owners are free to take advantage of speculative increases in their value. If we provide new incentives to maintain use for some limited period of time under a new profit motivated ownership, then we are only putting off a new day of reckoning. In 15 years, or 20 years, or whenever, we are going to be back in this hearing room, discussing what we can do to prevent the next generation of owners from removing the units from the affordable housing stock when the restrictions you enact in H.R. 3663 expire.

The bill should be amended to require that in order to transfer the property to a profit motivated buyer, a seller must certify that he has offered the project for sale first to qualified nonprofits and/or the tenants of the building, and no suitable purchaser has been found. The provisions of Title II of the HCD Act of 1987 governing prepayment of loans made by the Farmers Home Administration Section 515 program include similar language requiring that owners first offer the properties for sale to nonprofits. I urge the Committee to adopt a variation of this language to insure that the tax incentives proposed in this bill are made available first and foremost to facilitate the transfer of properties into a nonprofit, social housing sector which will insure their availability for low income people in perpetuity.

3. **Where for-profit owners buy the properties and sellers take advantage of these new incentives, the buyers should be required to guarantee low income use in perpetuity.**

Even when sales are made to profit motivated buyers using these tax incentives, guarantees should be required that the properties' low income use will be preserved beyond the remaining term of the mortgage. Otherwise, the bill has the undesired potential of creating a wave of property transfers that will cost the Treasury money and only postpone the crisis, not resolve it. The costs of this bill to the federal government are negligible when compared to the costs of displacement and homelessness among the current low and very low income tenants. But these expenditures should be designed first and foremost to guarantee that the units remain affordable to low income people.

4. **Where transfers are carried out under these proposals, there must be requirements that the sales price really reflect the reduced exit taxes which will have to be paid by investors, and that the subsidy is being passed along to the buyer and tenants, not solely to the seller and his or her investors.**

5. **The requirement that profit motivated buyers guarantee that they will contribute sufficient capital to repair and restore the project to sound financial and physical condition should be extended. Where profit motivated sellers are offering the property to nonprofit buyers or tenants, the Committee should consider applying a similar requirement on the seller.**

The relatively free availability of the proposed new tax incentives in this bill could stimulate some owners to offer their neglected properties to nonprofits or tenants at so-called "bargain sales." The incentives could offer sellers a way out of properties which they have failed to adequately maintain, without requiring that the transfer be based on some warranty of habitability or soundness. It is possible to envision a scenario where an owner could demand tenants organize to buy the building, or face the possibility of displacement through sale or foreclosure through an owner default. Tenants might end up acquiring a property needing large amounts of modernization or repair, without having the capital to carry it out. This is particularly true given the inadequate definitions of a qualified property, as noted in section 1 above.

If the bill's objective is to stimulate the transfer of properties and maintain their low income use, the Committee should include requirements governing the condition of the buildings on transfer. It is hard to understand why the requirement to assure that physical and financial problems will be resolved applies only to profit motivated buyers in the bill.

On a final note, I urge the Committee to consider balancing out this proposed legislation with disincentives which would apply to owners who sell their properties without restrictions for continued low income use. Such disincentives would serve two purposes: to discourage owners from taking advantage of the opportunity to sell or convert federally subsidized properties by in effect discounting their sale value, and returning to the Treasury some portion of the profits which will be made when such sales cannot be stopped to provide funding to preserve the remaining stock.

The Committee should actively consider a windfall profits tax on properties on which HUD-assisted mortgages are prepaid through sale or refinancing. Such a tax need not be confiscatory to deter some owners from selling. But for many of these projects, financial success for 20 years has hinged on a continuing flow of federal funds. If owners now wish to take advantage of a fortuitous change in the market, the government has a right to seek a share of the profits.

This is as fair as the demands which owners make that the federal government protect them from other market forces which are less felicitous. For example, Congress has enacted the Flexible Subsidy program to provide additional subsidies to maintain the economic viability of insured and subsidized projects. It has also made available extensive Section 8 assistance to bolster such projects and insure their continued availability to very low income tenants while providing owners a reasonable return. This is the right thing to do. But the government should not be only a "foul weather friend." Where owners choose to remove housing from its social mission in order to maximize return on their investment, the government has the right and responsibility to tax a portion of the resulting gain in order to assist in preserving the units that cannot or choose not to take advantage of a changed market situation.

LOW INCOME HOUSING TAX CREDIT

Mr. Chairman, I would like to conclude with some comments on the low income housing tax credit. The National Low Income Housing Coalition first proposed such a credit in testimony before this Committee in 1985. We're pleased and proud that Congress enacted it. We're grateful for your support of the credit and the Committee's interest in overseeing its administration.

The tax credit for low income housing was enacted to replace other incentives which were abolished in the 1986 Act. At the time of its initial consideration, we and others who worked with the House and Senate on the credit's creation emphasized that without other subsidies, projects could not meet the credit's strict targeting requirements. We vigorously supported those increased targeting requirements, because we believe that the government should limit subsidies for development to projects which serve a clear national purpose. The development and preservation of low income housing is such a purpose. The low income housing tax credit was designed to stimulate investment in properties that would not be able to compete for capital otherwise.

The record of the last year has borne out our early predictions. Tax credit projects can be carried out. But they cannot successfully meet the targeting requirements of the program without other subsidies.

These subsidies can come from a variety of sources--federal programs such as the Farmers Home Administration Section 515 loan program, CDBG grants, state and local government assistance programs, and philanthropic contributions. But whatever the source, all of these subsidies serve the same purpose: to close the gap between the costs of producing or rehabilitating rental housing for very low income people and the rents which those households can afford to pay. The Committee must recognize that the development and preservation of affordable housing for very low income people requires large subsidies on a long-term, ongoing basis.

The credit is far from perfect. The Committee yesterday heard several witnesses call for changes, many of which were included in the Technical Corrections bill adopted last year but dropped late in the session. We support passage of these changes. They are absolutely necessary if the credit is to reach its full potential.

10 Year Placed in Service Rule

In particular, there is an urgent need to clarify the provisions under which projects can receive a waiver from the rule prohibiting the acquisition credit for properties last placed in service less than 10 years before acquisition for credit purposes. The legislation should be amended to clarify that if a project is foreclosed by HUD or another public agency, it is automatically cleansed of any taint caused by the 10 year rule. Alternatively, the law could be changed to simply exempt such properties from the rule altogether, which would be an easier and less cumbersome solution.

This is particularly important for HUD-foreclosed properties, which may have changed hands once or several times in the years immediately preceding foreclosure as HUD tried to work with different owners to save the project. The law should make it absolutely clear that such transfers prior to a foreclosure do not come under the coverage of the 10 year rule. A foreclosure should "restart the clock" for the project. This is essential because if properties cannot be transferred out of HUD ownership using the credit, they will languish in the HUD inventory, costing the taxpayers money and jeopardizing the continued maintenance and liveability of the units.

HUD does not have a good track record as a manager of foreclosed properties. Congress should be promoting policies to encourage the recycling of these projects with continued low income use restrictions. Allowing the use of the credit for acquisition purposes, regardless of the transfer history prior to foreclosure is essential to do this.

This section of the law should also be changed to permit a waiver when necessary to help avert a mortgage prepayment and to preserve a property's low income use restrictions. This is very important in the HUD-assisted stock I described earlier in my testimony. Where owners are weighing the possibility of a sale or refinancing which would result in prepayment of the mortgage, the possibility of selling to new owners who would receive full tax credit benefits in return for maintaining the low income use restrictions could make the difference in preserving the housing. The cost of adding this waiver condition would be negligible, while the loss of the housing would be irreplaceable.

Refundability

The Committee should seriously consider making the credit refundable. Many nonprofit organizations are reluctant to take advantage of the tax credit because they cannot use it without giving up ownership of the property. Refundability was part of our original proposal to the Congress in 1985. It would offer the possibility of financing housing which would start out and end up in the nonprofit or social housing sector, free of the expiring use concerns which are now preoccupying us.

The truth is that the tax credit is sowing the seeds of another prepayment disaster in 15 years. Once the compliance period for the credit has expired, conflicts will inevitably arise between the profit motivated owners of the property, who acquired their interest principally for tax benefits in the first place, and residents and/or nonprofit sponsors, who will want to maintain the low income use indefinitely. This need not be so. I urge the Committee to amend the credit program to avoid this result.

Disposition After Compliance Period

The tax credits require that use restrictions remain in place for 15 years. While this provides substantially greater low income use than previous tax subsidies, there is no question that in 15 years many properties will be facing the same catastrophe now confronting the Section 236 and 221(d)(3) stock: conversion to non-low income use because of sale or refinancing at the end of the compliance period.

Congress should act now and consider ways in which to insure that tax credit housing can be transferred into social or nonprofit ownership at the end of the compliance period through agreements reached now between sponsors and investors. If sponsors are forced to wait until the end of the period to negotiate such transfers, they may be overtaken by economic and market trends which overwhelm whatever good intentions investors had in 1988. The law should explicitly bless front-end agreements in which investors' interests are donated to a nonprofit sponsor at the end of the compliance period. This is a poor second to making the credit refundable, and eliminating this entire transaction, but it would be better than the current law. The Committee should also change current law to enable corporations to participate in pooled income trusts which invest in low income tax credit-eligible properties. This device serves the long-term preservation goal by permitting the investors to donate their interests in the property at the front end of the deal. There are tax-credit investments being structured for individuals using this device. Corporations also should be allowed to participate, since they are the largest single investor group in the credits.

Repeal the 1989 Sunset

Unless the Committee acts quickly to repeal the 1989 sunset provision in the tax credit, investor and developer interest in the program will fade quickly after the 1988 tax year. Development and preservation take months to plan and carry out. It will be difficult to attract serious interest in tax credit proposals once we enter 1989, because investors will not be able to count on the credit's availability if their projects cannot be completed by the end of the year. More importantly, whatever pipeline is building up will quickly evaporate once 1989 arrives, again because of the threat of the sunset.

Restrictions Against Homeless, Disabled

Because of the wording of the Conference Report and the Blue Book, Treasury is reportedly interpreting the statute to prohibit the use of the credit in projects which are designed for homeless people, or for disabled residents. The relevant language in the report and Blue Book explains that the credit can only be used in properties which are available to the general public. This is being interpreted to rule out properties which are designed to meet certain populations' special needs.

The Committee should act quickly and unequivocally to eliminate this obstacle. The intent of the law should be to require that sponsors make the housing freely available to all who seek it. But Congress has long recognized in other programs and in other tax treatment that specialized housing may be designed for particular part of the population, within which nondiscriminatory rental and marketing practices are followed. Clearly, projects which only permit members of a certain racial group, or fraternal order, or religious affiliation should not be permitted to receive credits. But projects which are designed to provide affordable housing to low income disabled persons, or to homeless families needing transitional shelter should not be barred from the program.

Limitations Where Other Subsidies are Used

One of the most crippling provisions of the current law is the restriction against using the full rehab/development credit where other federal subsidies are being used. This limitation is senseless in most circumstances. The fact is that tax credit properties cannot be made affordable to the intended income group without additional subsidies. The current language encourages sponsors and developers to engage in imaginative stratagems to hide subsidies, or allocate them to acquisition, where the penalty does not apply, or to rely entirely on Section 8 subsidies, which are exempt from the general prohibition, in order to maintain affordability.

This restriction was placed in the law to hinder so-called "double dipping" in federal subsidy funds by sponsors and developers. It was founded on a belief that huge profits could be made through the application of the tax credit to projects already receiving enough assistance to be economically viable. This restriction is a reaction to a milieu which no longer exists, and did not exist at the time the 1986 Act was adopted. If there are instances where current direct federal subsidy programs make the full development credit too rich, then the law should address these exceptions. They are not the rule. Moreover, the current law already empowers states to allocate less than the full credit amount. This authority can be used to adjust the value of the credit to provide owners and investors with fair but reasonable rates of return on their investments.

Unlike previous tax incentives, tax credits are only available for units which actually serve low and very low income people, with rents which are strictly limited. The tax benefits are targeted for a specific purpose. By so restricting the credits, it becomes essential to have unfettered access to other subsidies--regardless of their source--in order to meet the credit's requirements.

HOUSING ASSISTANCE EQUITY

There have been many other suggestions for improvements in the credit which I urge you to consider. I would like to close by making one final point.

Since 1981, direct federal commitments for low income housing have plummeted by over 75 percent. Commitments to provide assistance to new families have been reduced from over 200,000 in fiscal 1981 to less than 80,000 in fiscal year 1988. In FY 89, outlays for HUD-assisted housing will rise to their highest level in history: a mere $12 billion.

At the same time, this Committee has presided over the continuing expansion of the most lucrative and poorly targeted housing subsidy system ever. Over $40 billion in untargeted tax subsidies will be spent this year to subsidize high income homeowners. I recently analyzed the distribution of these benefits among different income groups, using the Joint Committee on Taxation's income and tax liability estimates for FY88. The findings are quite interesting.

A total of 29.6 million filers will claim the homeowner mortgage interest deduction in FY88. Together they will receive $27.7 billion in tax subsidies. Of this total, only 35.5 percent will have incomes above $50,000. Yet they will receive 66 percent of the subsidies. Only 13 percent of those claiming the deduction will have incomes over $75,000 per year, but these filers will receive 35 percent of the dollar value of the mortgage interest deduction subsidies.

These figures are disturbing enough. They mean that 4 million filers with incomes above $75,000 will receive nearly $10 billion in housing subsidies from mortgage interest deductions, and another nearly $3 billion from property tax subsidies, or more than all of HUD's subsidies for the total universe of 4 million low income households now receiving HUD assistance.

When you compare these very high income filers with the total filing population--not just those claiming the deductions--the proportions are even more unbalanced. While only 11 percent of all filers will have incomes in excess of $50,000, they will receive 66 percent of the value of the homeowner deductions. Those filers with incomes above $75,000 make up only 3.7 percent of all filers, yet they will receive 35 percent of the homeowner deduction benefits.

I highlight these facts because some members and staff have vigorously opposed the low income housing tax credit because of its cost. Yet the same publication prepared by the Joint Committee on Taxation estimates that total revenue losses from the use of the low income housing tax credit will equal $300 million in FY88, $600 million in FY89, and $900 million in FY90. Every one of these subsidy dollars will be spent to stimulate investments in properties which must by law provide housing for people with incomes below 60 percent of the area median income, at rents which cannot exceed 30 percent of that ceiling income level.

I submit to you that in comparison with the need, and in comparison with the extraordinary and inequitable tax subsidies this Committee countenances for homeowners with the highest incomes in the country, continuation of the low income housing tax credit is a modest contribution to assuring that we meet the goal of a decent, affordable home for every American.

Thank you for the opportunity to testify here today. I will be happy [illegible] answer any questions you may have.

Chairman **Rangel.** Well, I want to thank this panel for its thoughtful observations, the work it's doing in this area, and the help that you have given to this committee to get where we are and to know that we will be calling upon you individually or collectively as we move on to fashion a final bill to present to the full committee and our colleagues in the House.

Mr. Zigas, I can understand why you would want to allow the investor to know up front as to what the conditions are of resale.

How do you dovetail that with the windfall profit tax for sales of appreciated low-income housing? I know you don't see any inequity in doing it, but do you see any illegality in changing the rules of the game?

Mr. **Zigas.** Well, I have the advantage, Mr. Rangel, of not being an attorney so I really can't comment on that.

But I think we have changed the rules very substantially on the way we treat investors in low-income housing. I think Mr. Heller's testimony is pretty eloquent on that point. I mean in fact we continually change the rules under which investors participate in this program.

A windfall profit tax need not be confiscatory in order to serve a purpose, which would be to discount the value of the property so the decision to sell might be a little harder to reach, and to raise money for the Treasury frankly to ensure that those properties that don't have an opportunity to sell, and for which investors cannot be found, and for which general partners are unwilling to invest additional money, can be preserved and new funds can be put in them to guarantee that the housing remains well maintained and a decent place for low-income people to live.

Chairman **Rangel.** The GAO testified this morning that additional tax incentives should be made available for owners of low-income housing where HUD or the Farmers Home Administration made a determination that it was necessary to give these additional incentives.

Do you concur with that, to give them the option to review and only to provide them for those that need it as opposed to across-the-board incentives?

Mr. Rozet.

Mr. **Rozet.** I guess my orientation is that we will always have the problem as long as we continue the housing in the hands of tax-oriented investors.

I see it as a moving of ownership from one disinterested investor to an investor—I use State agencies or nonprofits as an example. So my feeling is the incentives you're giving in section 4 of H.R. 3663 are important incentives in themselves.

I don't know that you need additional incentives except where we come across cases where owners are willing to commit them to housing, but they need money to fix the housing and to repair or upgrade it.

Then I think you need some additional tax incentives, and some I suggested in my presentation as part of the record.

I do agree some are needed, but I think the first step is to move the properties from what I'll call the disinterested, the passive investor, into the hands of communities or tenants or State agencies, or those who are committed to maintain them, perhaps not for just

15 years, by the way, I haven't commented on that, but I think for the remaining life of the mortgage at a minimum should be the commitment of anybody who takes a low-income housing project with additional incentives.

Chairman RANGEL. Thank you.

Ms. Lewis, I know you would want us to broaden our target in order to provide support for co-ops generally rather than low and moderate.

Do you have any ideas how we can give assistance to co-ops generally and have any feeling that the owners would allow them to stay low and moderate cooperatives rather than seeking out the value of the appreciation and the value of the property?

Ms. LEWIS. Well, Mr. Chairman, what I'm suggesting and what my organization is suggesting is that the situation in which commercial income is allowed to write off against the cost of providing the housing should be very well targeted.

That's a situation in which the interpretation of the Internal Revenue Code that the IRS is currently holding, whether it's judicially upheld or not, has some social policy behind it.

The place where I'm suggesting that the bill be broadened is a situation in which an essential part of co-op functioning altogether is being taxed, not simply taxed, but taxed as if it were a for-profit separate enterprise. And it's already taxable income under subchapter T of the code.

We're not arguing that we're asking for an exemption from taxation like a tax credit or tax losses. We're talking about what's taxable income, but income that should not be subject to more onerous taxation than either a single family homeowner or a for-profit corporation.

Chairman RANGEL. So you separate that question, that IRS controversy, that's in the courts completely away from the income question, that that's just a question of fairness no matter what the income is or no matter what the owner decides to do with the development.

Ms. LEWIS. Yes. And I think it's appropriate to be dealt with here because the bulk of cooperative housing is in fact serving the purposes of this subcommittee.

Chairman RANGEL. And when you talk about the ability to use the commercial rents to make certain that affordable housing is there, are you talking about existing descriptions as to what is affordable housing? Your association does not have any preconceived ideas as to what the cap is on affordable housing?

Ms. LEWIS. Your notion is to look at the limited equity portion. There are two aspects in looking at whether or not a co-op is affordable. It's ongoing costs for existing members and its turnover costs for people who are coming in.

I think that the subcommittee is well advised to look at both.

Using a limitation as to equity means that the people who buy in are going to tend to be low-income folks.

In limited equity co-ops there is a targeting or a restriction generally on who may become a member. That's not always the case, but it's often the case. And some language adjustments may be necessary because the definition of limited equity co-op was created for the mortgage revenue financing bill, and there were many limited co-ops that existed prior to that that may not precisely meet that definition but that are, in fact, bona fide limited equity co-ops.

But looking at both aspects of affordability, the affordability of becoming a member and the affordability of remaining a member would be a good idea in terms of preservation of affordable housing.

Chairman RANGEL. This has been one of the best panels that I've had come before this committee. And clearly you shared in your broad experience and the many years that you've had in this area with us. We seldom find ourselves experts in anything.

It has been very, very informative, and I promise you we'll be back.

Mr. McGrath.

Mr. MCGRATH. Mr. Chairman, I share your assessment of this panel. I think they've brought up some very good points to help us create the kind of incentives that are needed in order to preserve low-income housing but also balance whatever windfalls may occur because of tax credits and loss of revenue to the Treasury.

I am delighted to have you here before us and to add your testimony and your written testimony to the record of this hearing. Thank you.

Chairman RANGEL. In the course of this proceeding, if there's something that we missed in the testimony or some shifts that you see out, that you would feel free to write to me and to point out that I asked you to do it so that we will be able to make certain that the record remains open officially as well as unofficially.

Thank you very much for your support.

The committee stands adjourned.

[Whereupon, as 12:20 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF THE AMERICAN ASSOCIATION OF RETIRED PERSONS

The American Association of Retired Persons (AARP) is a membership organization of over 28 million older persons. We appreciate this opportunity to present our views on the low-income housing tax credit and the preservation of the stock of low-income housing.

AARP's recommendations can be summarized as follows:

1) Eliminate restrictive interpretations on use of the credit for projects designed to serve the frail elderly and other special populations.

2) Eliminate or modify the family size adjustment for developments serving the elderly or other special populations.

3) Extend and permanently authorize the low-income housing tax credit and modify the carryover provisions to allow more flexibility in use of the available credit allocations.

4) Eliminate or modify the limitation on the use of the full credit where other federal subsidies are used.

5) Provide incentives to assure that housing built with the credit remains available to low-income tenants after the expiration of use restrictions.

6) Assure that new tax incentives proposed under HR 3663 are targeted to projects primarily serving low-income tenants.

7) Extend first purchase option to non-profit or public buyers before permitting transfers of properties and activation of incentives under HR 3663.

8) Require certification of habitability before permitting transfers of properties under HR 3663.

Potential Loss of Assisted Housing Occupied by Low-Income Older Tenants

AARP is very concerned about potential reductions in the current inventory of assisted housing due to the prepayment of federally subsidized mortgages and termination of Section 8 rental subsidies. A reduction in the number of available low-rent units is unacceptable, given current unmet needs. To replace these units would be extremely expensive at today's construction costs.

Prepayment of federally subsidized mortgages threatens to displace thousands of low-income and older tenants living in multi-family projects produced under the FmHA Section 515 Rural Rental, HUD Section 221(d)(3) Below Market Interest Rate (BMIR), and HUD Section 236 Rent Subsidy Programs. Current contracts require that the HUD units be limited to low-income tenants for a forty-year period, but certain owners may prepay the morgtgage after twenty years, terminating all restrictions on use of the property. In the case of FmHA Section 515 units built prior to 1979, loans can be prepaid at any time without agency approval.

Large scale prepayments by owners would be disastrous for many older persons. Approximately 48 percent of all Section 515 units, 24 percent of Section 236 and 12 percent of 221(d)(3) BMIR units are occupied by older persons. According to a recent GAO report, 143,530 FmHA Section 515 rural rental units built before 1979 can be prepaid immediately without agency approval. Another 131,639 Section 515 units would be eligible after 1999. In addition, at least 217,544 units (53,850 Section 221(d)(3) and 163,694 Section 236) will be eligible for prepayment without HUD approval between 1986 and 1995. All in all, we estimate that FmHA and HUD projects serving the elderly and eligible for prepayment within the decade ahead represent 7 to 10 percent of all federally subsidized housing for older Americans.

The potential loss of federally assisted housing takes on special significance in light of overall reductions in federal assistance for new construction and substantial rehabilitation. As the federal government withdraws its support for new construction, the number of low-rent units, both public and private, is projected to decrease. A recent report by MIT indicates a further reduction of 27 percent in the supply of low-rent housing between 1983 and 2003. The total number of households needing low rent units will increase by 44 percent during that same period.

Currently, long waiting lists exist at most federally assisted housing projects for older persons. A recent report by the Congressional Research Service noted that "when family and unit size are taken into account, there is no area in which the supply of standard quality vacant units is sufficient to permit all unsatisfactorily housed families to move into units in which they would not be overcrowded." While shortages are most critical for large families, the report notes shortages exist in many areas for the one and two bedroom units needed by older households.

AARP's concern is that many of the older tenants living in these assisted projects lack the ability to easily relocate or to pay rents substantially higher than what they are already paying. We believe that, in assessing federal policy with respect to preserving assisted housing, the hardship to which current tenants are exposed should be a major consideration, along with cost effectiveness. From either standpoint, we believe the arguments are compelling for trying to help tenants stay in their current residences.

The Congress made a good start in addressing the preservation issue with the passage of the Housing and Community Development Act of 1987. Title II of the Act would permit prepayment to occur only when owners have a HUD approved "plan of action" designed to meet the housing needs of those tenants displaced by conversion to other uses. Nonprofit organizations and public agencies would be given a first purchase option. Most importantly, the Act also empowers HUD to negotiate with owners and offer incentives in return for maintaining projects as low-income housing.

AARP believes that the low-income housing tax credit and the incentives under HR 3663 could play a vital role in a comprehensive federal strategy aimed at preserving the current stock of low-income assisted housing units. We would like to suggest some changes to the current low-income housing tax credit and HR 3663 which we believe would improve their utility and effectiveness, particularly in addressing the needs of older tenants.

Eligibility for Credits of Specialized Housing for Older Persons

A major handicap to use of the credit for projects housing low-income older tenants is the Department of Treasury's interpretation that the statute only allows the credit to be used for properties "available to all members of the public." This interpretation would eliminate from consideration projects designed specifically to serve the frail elderly, disabled persons, the homeless or other special populations.

The federal government has long recognized the appropriateness of specialized residential housing in both tax law and housing programs. Specialized residential housing for the frail elderly and disabled has always qualified for tax benefits as long as it is administered in a non-discriminatory fashion. AARP believes that Congress intended to maintain this precedent in the Tax Reform Act of 1986 and we urge the committee to affirm this intent.

Another definitional problem concerns the term "retirement home" as used in the statute and the phrase "retirement home providing significant services other than housing," as used in the General Explanation of the Tax Reform Act of 1986 (Blue Book) prepared by the staff of the Joint Committee on Taxation. "Retirement home" is an ambiguous term that is not defined in the current literature on housing for older persons. The uncertainty over what is meant by "retirement home" and "significant other services" has inhibited project development in several instances.

AARP feels strongly that congregate housing and board and care facilities that serve an elderly population and provide non-medical services that assist in maintaining the resident's independence should not be excluded from using the credit.

We have recommended that the following definitions be included in forthcoming regulations or legislation to clarify this matter.

> Congregate Housing Facility -- provides a semi-independent living environment with apartments, centralized dining services, and other support services, such as social and recreational programs and housekeeping.
>
> Board and Care -- a facility which provides food and lodging to adults who are not related to the owner/operator. Personal care and supervision are provided to varying degrees. However, those facilities licensed by the states as intermediate care facilities would not be eligible for the credit.

The availability of the credit for these types of housing would broaden the options for those older persons who do not require medical assistance but need some supportive services to remain independent. Many of these individuals now end up in nursing homes paid for by federal and state funds. Recent experience with the credit indicates it would be particularly useful in upgrading board and care facilities, which tend to be smaller and serve a very-low-income population. Some 54 percent of board and care residents receive Supplemental Security Income (SSI) payments. Use of the credit to rehabilitate these facilities would further the credit program's goal of making safe and sanitary housing available to those most in need.

Additional Modifications to the Low-Income Tax Credit

Another modification to the tax credit that would assist in the development of affordable housing for older persons would be elimination or modification of the family size adjustment. In areas where the median income is low, even persons receiving SSI payments might exceed the targeted income limit; thus the unit would not qualify for the credit. AARP believes states should have some discretion to permit the credit to be used in instances where a clear need is demonstrated. Another solution might be to permit more flexible allocation of total fees between rent and services.

AARP supports extension and permanent authorization of the tax credit program. We believe this would go a long way in improving investor confidence and willingness to participate in the program. Further, AARP encourages the committee to consider allowing corporations to participate in pooled income trusts such as the National Retirement Housing Trust, which could invest in credit eligible properties. This would provide a major vehicle for private sector investment to help meet the future housing needs of the nation's growing older population.

AARP also believes that Congress should reconsider the restriction against using the full credit where other federal subsidies are being used. The credit alone is simply inadequate to develop low-income housing in most areas. A recent report of the Council of State Housing Agencies notes that nearly 80 percent of all credit projects received some other federal or state subsidy. States already have authority to reduce the credit amount where appropriate. Because the credit is targeted only to those units that actually serve low income tenants, we believe the chances for abuse are minimized. The current restrictions prevent many projects from being undertaken.

AARP also supports modification of the credit carryover provisions to allow carry-over for projects that are substantially ready but miss the December 31 deadline. This change would recognize the difficulty of low-income development where a variety of financing sources must be arranged and delays are frequent.

Finally, AARP believes that the committee should consider incentives to assure that the housing built with the credit remains available to low-income tenants after the expiration of the use restrictions. This might take the form of front-end agreements to donate properties to nonprofit sponsors or, as previously mentioned, allowing corporations to invest in pooled-income trusts that support nonprofit ownership. Such incentives are needed if we are to avoid a displacement problem 15 years in the future.

Recommendations on HR 3663, The Low-Income Housing Tax Act

HR 3663 would complement the preservation provisions of the Housing and Community Development Act of 1987 and provide some important new incentives to preserve assisted housing. However, AARP does have concerns about the targeting of the tax incentives and provisions providing for transfers of properties.

AARP has supported the targeting provision incorporated into the low-income housing credit because of the need to restore some balance to the distribution of tax subsidies among low, moderate and upper income households. Under HR 3663 owners could receive considerable tax relief, even if only 20 percent of the units were serving low-income households. This trade-off may not be cost-effective, particularly in light of the generous tax benefits given to investors prior to 1986. Priority in the allocation of scarce tax incentives must be given to housing that primarily serves low-income households.

AARP also believes that a first purchase option for nonprofit and public buyers should be incorporated into HR 3663. Such a provision would make it consistent with Title II of the Housing and Community Development Act of 1987. AARP believes that if additional tax incentives are provided, priority should be given to ownership that will guarantee permanent occupancy by low-income tenants.

Finally, AARP supports inclusion of a certification of habitability before properties are transferred and the additional tax incentives activated. This would prevent owners from "dumping" neglected properties. Also, for-profit buyers should be required to show that they have sufficient resources to maintain and/or repair the property.

AARP would like to commend Chairman Rangel for introducing this legislation and scheduling these hearings on preservation of our nation's supply of assisted housing. Maintaining and expanding the supply of low-income housing is of critical importance to low-income Americans of all ages. We look forward to working with you and the entire committee in developing viable solutions to our nation's housing problems.

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March 16, 1988

Robert J. Leonard, Esq.
Chief Counsel, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Subcommittee On Select Revenue Measures
Hearings March 2 & 3, 1988

Dear Sir:

Associated Builders and Owners of Greater New York, Inc. ("ABO") members include a number of owners of government-subsidized low and moderate-income rental housing projects who are or shortly will be eligible to "opt out" of their respective governmentally-restricted programs. ABO supports HR 3663, sponsored by Chairman Rangel and Representative Frank, which would provide additional tax incentives to encourage the voluntary preservation of existing Federal, State, or locally-assisted rental housing for low and moderate-income use.

Given the almost total lack of new low and moderate-income housing development and the large number of housing units that are subject to being removed from the existing low and moderate-income supply as a matter of right over the next few years, we believe that it is critically important to provide new financial incentives to persuade the present owners of such housing to forgo their right to convert such properties to more profitable uses. At the same time, we firmly believe that any such measures must be voluntary and must not impair the owners' contractual right to prepay their government-subsidized mortgages and rent or sell their properties free from regulation under the government-subsidy program.

As we understand it, HR 3663 would provide the following tax benefits to owners of existing government-subsidized rental housing projects, who would otherwise be eligible to free their projects from program restrictions on rents or income, provided that such owners agreed to (i) continue operating the projects under the restrictions of the government-subsidy program for an additional period equal to the greater of twenty years or the remaining term of any government-subsidized debt on the property, and (ii) make capital contributions in an amount the appropriate government official determines to be necessary to restore the property to sound physical and financial condition.

1. The adjusted basis of the property would be increased to the original acquisition cost plus the amount of any expenditures for capital improvements incurred before the agreement date. This "stepped up" basis would determine the future depreciation deductions allowable to the owner as well as the amount of taxable gain on ultimate disposition of the property.

2. Assuming that 10 years have passed since the property was placed in service (or substantially rehabilitated) and the project, or a portion thereof, otherwise qualifies for the low-income housing tax credit, the owner would be treated as placing the property in service on the agreement date. The amount of the tax credit would be based on the "stepped up" basis described above.

3. The 10-year "anti-churning" requirement of the low-income housing tax credit would also be waived if (1) the appropriate government official determined that the availability of the credit was necessary to avoid default or enable the project to be retained for low-income use, or (2) the owner had acquired the property from a governmental body after a default.

Alternatively, non-corporate owners of existing low and moderate-income projects would be encouraged to sell their projects to (a) a non-profit tenants' organization or other non-profit entities whose exempt purpose includes the fostering of low-income housing, (b) a state or local government unit, or (c) a partnership that contributes enough capital to restore the project to sound condition. In the event of such a "qualified disposition", the seller or sellers of such property would be allowed to exclude from gross income an amount equal to the excess of the indebtedness on the property over its adjusted basis (without regard to the "step-up" referred to in 1. above). Thus, if such a disposition can be structured (which seems at first blush unlikely except in the case of a re-syndication to a new partnership which can take advantage of the other benefits provided by the bill), such non-corporate taxpayers could avoid being taxed on the "phantom gain" that occurs when a property has indebtedness in excess of adjusted basis.

While we applaud the concept of HR 3663 as a first step toward the enactment of the kind of voluntary incentive program that we think is necessary to encourage owners to continue to operate low and moderate-income rental housing projects under the restrictions of existing programs, we do not believe that the legislation will achieve its intended objective unless several important changes are made.

I. Exemption From Passive Loss Rules

Because the "stepped up" basis provided under HR 3663 will produce "passive losses" which are useable only against "passive activity income" for most non-corporate taxpayers, the benefits provided by the bill will have limited utility to individual and partnership owners of existing low and moderate-income projects. The present limited exception to the passive loss limitations of the Internal Revenue Code (the "Code"), permitting individual taxpayers with adjusted gross incomes of less than $250,000 to use up to $7,000 of the low-income housing tax credit annually to offset nonpassive income, has not achieved its purpose and certainly will not constitute a realizable benefit to many, if not most, owners of existing low and moderate-income projects. Thus, in order to make the proffered incentive real, the depreciation deductions generated by the "stepped up" basis provided by the bill must be exempted from the passive loss rules of the Code.

II. Housing Tax Credit Allocation

Without an increase in credit authority to the states, or an exemption from credit authority limitations, use of the low-income housing tax credit to encourage preservation of existing low-income housing could have the unintended effect of substituting preservation of the existing low-income housing stock for the addition of new low-income units to the stock when, in fact, both are sorely needed. Thus, we urge either an increase in funding for the credit sufficient to cover the anticipated preservation need or an exemption from the credit authority limitations for such preservation projects.

III. Technical Corrections

In order to make the low-income tax credit a viable incentive for either the preservation of existing low-income housing or the production of new low-income housing it is imperative that the Congress promptly enact both the technical and substantive modifications to that credit embodied in HR 3545 as passed by the House of Representatives in 1987, but not included in the bill as finally enacted. In testimony before this Subcommittee, Deputy Assistant Treasury Secretary C. Eugene Steurle conceded that the uncertainty engendered by the delay in enacting these critically-needed modifications has been a significant impediment to the use of the credit and urged that passage of these "technical corrections" should not again be delayed by "other unrelated considerations".

If HR 3663 is amended to incorporate the changes that we have recommended, we believe that the owners of a significant number of government-subsidized rental housing projects in New York City and New York State (including a large number of State and City-assisted "Mitchell-Lama" projects) will continue to operate their projects under the rent and income restrictions now applicable, or to sell to partnership which will agree to do so, in return for the substantial tax incentives that would be provided by the bill as so amended.

Respectfully submitted,

Associated Builders and Owners
of Greater New York, Inc.

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President

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March 16, 1988

Rep. Charles Rangel
Chairman, Subcommittee on Select Revenue Measures
Ways and Means Committee
U. S. House of Representatives
Washington, D. C.

RE: Low Income Housing Tax Credits

Dear Congressman Rangel:

I am responding to the invitation of your committee for written comments on the working of the low income housing tax credit provisions of the Tax Reform Act of 1986. I have been involved in and committed to the development, management and financing (including syndication) of low and moderate income housing for almost 25 years.

We recently completed construction of a 30 unit rehabilitation project which is eligible for the low income housing tax credit, and we recently started construction of a 178 unit new construction and rehabilitation project which is also eligible for the credit. Both are scattered site projects. In each project a non-profit neighborhood based housing redevelopment corporation is our equal 50%/50% joint venture partner.

From this background, I would like to comment on the low income housing tax credit:

1. The Technical Corrections Act, which was supposed to be passed with the 1986 Act, failed to pass in 1986 and again in 1987. There are provisions in the proposed Technical Corrections Act which are essential to the proper working of the low income housing tax credit. For example, there was a "glitch" in the original legislation with regard to Section 8 tenants whose incomes increase after they assume occupancy in the project; the Technical Corrections Act corrects this unintended problem. Perhaps the technical corrections to the low income housing tax credit could be enacted separately, since they should be essentially non-controversial; the amount of the credit is limited, so the changes would have no revenue impact.

2. The changes contained in the proposed Technical Corrections Act with respect to the ten year holding period are inadequate. The intention of the ten year period was that taxpayers not reap the substantial advantages of rehabilitating a property using the rapid ACRS or Section 167(k) write-offs and soon thereafter take advantage of the low income housing credit with respect to the same property. Presumably most Congressman and other knowledgeable laymen assumed that a project is placed in service when its initial construction is completed or when a major rehabilitation is completed and new tenants are allowed in. However, the statute is subject to the interpretation that the project is "placed in service" every time there is a new owner. Thus, if the property was transferred from one slumlord to another with no improvement and no significant new depreciation benefits, the property would nevertheless be

disqualified from the benefit of the low income housing tax credit for ten years notwithstanding a substantial rehabilitation during that period by a responsible purchaser. This is an absurd result which could not have been intended. There is no valid policy reason for this interpretation, and Section 42 should be revised to preclude this interpretation.

3. There should be a provision (really a technical correction) permitting the credit to be allocated by "project" or some such term rather than by "building." The result of the use of the word "building" is that our 178 unit project may need somewhere between 46 and 76 separate allocations -- one for the acquisition of each of our 38 scattered site buildings or vacant lots and one for the rehabilitation or construction of each building. We will allocate of construction costs among all of the buildings on some theory, since a single contractor makes a single bid for all of the construction. We also have to predict in advance when each building will be finished, since if we guess the wrong year for completion we may lose our credit (see paragraph 4, below). We will have to keep track of the completion date of each building for the next 15 years. For ten years, each building will be on a different credit schedule. Additionally, the credit allocating agencies in Illinois (and probably many other states) charge an administrative fee which is not only a percentage of the credit, but also a flat fee per building, which results in an excessive and burdensome fee for scattered site projects. The owner/taxpayer should at least have the option of applying for a single credit where there is a single mortgage and/or construction contract and/or owner.

4. Under existing law, the credit percentage is not known until the project is completed. The proposed Technical Corrections Act allows the credit percentage to be fixed at the beginning of project construction rather than at the end, which is an important improvement.

5. Even more important, however, under existing law the credit allocation must come out of the year in which the project is completed and allocations cannot be carried over from one year to the next. The credit allocation should be made from the year in which construction begins rather than the year in which it finishes. Our situation illustrates the problem perfectly. We started construction on our scattered site townhouse and rehabilitation project in February. Units will probably be completed starting in October, 1988 and ending in the spring of 1989. It is impossible to predict accurately the completion date of each building. We are subject to weather conditions, strikes, shortages of materials, delays in deliveries, etc. Yet if we take a 1988 allocation and do not finish in 1988, the agency may be unwilling or unable to issue us 1989 credits. On the other hand, if we initially take 1989 credits but finish in 1988, and the agency is unwilling or unable to allocate us 1988 credits at the last minute, we will either lose the credit entirely or be forced to keep the units empty until 1989, foregoing substantial income and preventing good low income housing from being available to needy families, a ridiculous result.

6. The program is schizophrenic in that it provides a credit to help low income housing, but then puts restrictions on it that make it unavailable to practically all of the investors who might be able to use the credit and who can afford to make investments in low income housing. Investors who take advantage of the credit are not avoiding paying "their fair share" of taxes. They are putting their money directly into low income housing, which is unlikely to give them any return other than the credit, instead of funneling the money through the federal government, which has done a particularly bad job of financing public housing directly. Under these circumstances any investor should be permitted to utilize the credits regardless of the investor's annual income. As it is, no individual who makes a lot of money or thinks he might make a lot of money in the next ten years (or that Congress might change the rules) would or

should be interested in investing in low income housing tax credit projects. This restricts the market for placing these investments, which reduces the capital which can be raised by developers. Eliminating the imposition of these "passive loss" limitations on low income housing tax credit investors should have no budgetary impact, since there is an annual dollar limitation on the amount of low income housing tax credits available.

The foregoing are among the important improvements which should be made immediately to the low income housing tax credit, and which should be relatively non-controversial. Anyone who opposes these changes is probably using them as an excuse for opposing the credit itself, hoping that its difficulties and complexities will make it unusable. However, there is a much more significant change which should be made in the low income housing tax credit which would make it substantially more effective in accomplishing its goals:

The credit should be "refundable," i.e., the owner of the property (or perhaps the partners or shareholders of the owner in the case of a pass-through entity) should file a tax return showing the amount of credits for which the project (or the partner) is eligible. If the amount of the credit exceeds the amount of tax owed, the government should send a "refund" check to the taxpayer. This could apply to tax-exempt entities as well as taxable entities. The budgetary impact would be exactly the same as the present law. However, the amount of the credit which would benefit the project would be substantially increased. The process would be speeded up and simplified. The participants in the syndication process who have so often been pilloried by the Congress and others would be eliminated from the process. In other words, syndicators, brokers, syndication attorneys and accountants, and investors would no longer be a part of the low income housing development process. This should be very appealing to those Congressmen and others who argue (mistakenly) that the doctors, dentists, lawyers and businessmen who made the investment which Congress induced them to make in order to carry out the governmental function of providing low and moderate income housing are "not paying their fair share."

To the best of my knowledge, for every dollar which the Treasury loses because of the low income housing tax credit as now constituted, the actual developer of the housing receives between $.35 and $.45. Some of this shortfall has to do with the present value of investor payments as compared to the present value of the ten year credit. But most of it is due to the (necessary) costs of raising money, including the time, efforts and substantial risk taken by syndicators, lawyers, accountants, brokers and others who must do their due diligence, as well as a (justified) skepticism on the part of investors who have been badly hurt recently by retroactive congressional changes in the federal income tax. If the credit were made refundable, every dollar that left the Treasury would go directly to the producer of the housing.

The low income housing tax credit approach to the production of low income housing is certainly not an ideal solution, but it is the only method presently available for providing any real volume of badly needed housing for low income families. Many improvements could be made in addition to those described above. However, adoption of the above-referenced suggestions would substantially simplify a very complicated process and would ensure that the government would get a lot more bang for the buck than it now does from the low income housing tax credit program.

Thank you for your consideration of my views.

Sincerely,

Sheldon Baskin

Sheldon L. Baskin

STATEMENT OF RICHARD L. O'TOOLE, BATTLE FOWLER, NEW YORK, NY

This Submission relates to the hearings held by the Subcommittee on Select Revenue Measures of the House Committee on Ways & Means on March 2 and 3, 1988 concerning tax incentives for low-income housing.

I am a partner in the law firm of Battle Fowler, which represents a number of clients active in the development of low-income housing. Our clients currently are engaged in development work that is expected to produce in excess of 1,000 units of low-income housing in the greater New York area. Although the low-income housing tax credit set forth in Section 42 of the Internal Revenue Code is, in general, of substantial assistance in the development of low-income housing, a number of clarifications and changes to the credit are necessary in order to insure that the credit will function in the manner originally intended. This Submission addresses changes to the low-income housing credit that were included in H.R. 3545, passed by the House of Representatives in 1987.

Substantive Amendments to the Low-Income Housing Credit included in H.R. 3545

In 1987, a number of important changes to the low-income housing credit, passed by the House of Representatives in H.R. 3545, were deleted during the final development of the Revenue Act of 1987. These provisions would resolve a number of troublesome issues that could not have been foreseen at the time the low-income housing credit was enacted. It is imperative that certain substantive and technical amendments included in H.R. 3545 be enacted in order for the low-income housing credit to operate as contemplated. The most essential elements included in H.R. 3545 are as follows:

(a) H.R. 3545 provided that credit authority could be carried over by a State for specifically identified projects where a project could not be placed in service due to unavoidable circumstances beyond the control of the developer. This change and an amendment in H.R. 3545 that would permit carryovers in the case of new construction and rehabilitation projects without regard to special circumstances are necessary to allow for the significant difficulties encountered in urban construction, particularly in areas such as New York. If this change is not adopted, it is possible that residential construction projects intended for occupancy by low-income tenants will be converted to market-rate housing if construction delays are encountered, because operation of a project as low-income housing will not be economically viable in the absence of the low-income housing credit.

(b) H.R. 3545 provided that decreases are not made in a low-income tenant's rents to reflect certain reductions in family size. The viability of low-income housing developments depends upon the ability to predict, with a high level of certainty, that rental revenues will be sufficient to cover maintenance and operating expenses.

(c) The House Ways & Means Committee Report on H.R. 3545 included a provision, printed on page 1522, entitled "Certain zoning swaps," to the effect that the Committee intended that a housing project not be disqualified from receiving the low-income housing credit solely because state and local programs intended to foster low-income housing provided the owner of the housing zoning variances for other, non-low-income-housing property.* It is imperative that Congress clarify that restrictions placed on housing by an owner, which are consistent with use of the housing by low-income tenants, will not jeopardize the availability of the credit. Accordingly, we suggest that the following language, which is similar to the provision included on page 1522 of the House Ways & Means Committee Report on H.R. 3545, be included in legislation or in an accompanying committee report:

> A housing project shall not be prevented from qualifying for the low-income housing credit because of a commitment undertaken by the owner to maintain the project as low-income housing in order to receive zoning benefits.

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* Restrictions on an owner's ability to maximize profits that are imposed by Section 42 of the Internal Revenue Code and by state and local programs intended to foster low-income housing raise technical questions as to whether tax benefits available to the owner could be disallowed on the basis that the owner did not have a sufficient profit motive, did not "own" the housing for federal income tax purposes, or did not satisfy other general criteria for tax benefits. In the past, e.g., Rev. Rul. 79-300, 1979-2 C.B. 112, these questions have been resolved by a recognition that restrictions imposed by governmental authorities on rental housing should not prevent the owner from qualifying for the very tax benefits that are received as a result of low-income restrictions.

California Association of Housing Cooperatives
A Non-Profit Corporation

In Memoriam
Jerry Voorhis
Claremont, CA
Executive Director
Lydia Joseph
San Francisco, CA
Treasurer
Elizabeth (Ross) Woodard
San Rafael, CA
Assistant Treasurer
Edward Boyce
San Jose, CA

March 15, 1988

Mr. Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways & Means - Re: HR 3663
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Regarding: HR 3663

Dear Mr. Leonard,

The California Association of Housing Co-operatives is a statewide organization of housing co-operatives. These co-operatives represent a source of affordable housing consistent with your attempts to preserve this country's affordable housing stock.

We encourage you to broaden HR 3663 to preserve affordable housing by allieviating inequitable taxation. As income which is integrally intertwined with the cooperatives functions, interest on reserves should be treated as member income. This income is demonstrably linked to physical and operational requirements of the cooperative and should be treated as part of the cooperative enterprise. The same is true for government subsidies and grants that make cooperative housing available to low and moderate income families.

As it regards Sections 5 & 6 of HR 3663, we support refinement to allow:

1. Interest from the prudent investment of reasonable reserves should be treated as member income.
2. Subsidies, grants and similar forms of income should be treated as member income.
3. Insurance proceeds earmarked for reinvestment should be treated as if already invested.
4. The 80/20 rule should be replaced by a principal purpose test.
5. Commercial income of limited equity co-operatives should be allowed to offset the cost of low income housing.
6. The definition of limited equity co-operative should insure the inclusion of all bonafide limited equity co-operatives.

Thank you for giving the above your attention.

In Cooperation,

Lydia Joseph-Jakobi

Lydia Joseph-Jakobi
Executive Director

2330 Marinship Way, Suite 200, Sausalito, California 94965
Telephone: (415) 332-7021

cc: NAHC

INTENTIONAL
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COMMON GROUND
107 Cherry St., Suite 410
Seattle, Washington 98104
March 2, 1988

Representative Charles B. Rangel
and Members of the Subcommittee on
Select Revenue Measures
Committee on Ways and Means
United State House of Representatives
Washington, D.C. 20515

Dear Subcommittee Members,

Common Ground is a non-profit charitable organization in Seattle, Washington dedicated to developing low-income housing on behalf of area non-profit, church, and community groups. Our testimony today suggests ways Low-Income Housing Tax Credits could result in greater use by non-profit charitable organizations of private equity while ensuring maximum public benefit through housing dedicated to low-income use in perpetuity.

Common Ground's comments address several problems that currently exist with respect to non-profit charitable organization use of private equity investment induced by the Low-Income Housing Tax Credit:

1. NON-PROFIT ORGANIZATIONS SEEKING TO DEDICATE THE HOUSING THEY PRODUCE TO USE BY LOW-INCOME PEOPLE IN PERPETUITY HAVE VERY FEW WAYS TO DO SO UNDER THE CURRENT TAX CODE WHEN WORKING WITH PRIVATE INVESTMENT CAPITAL.
2. PROPOSED LOW-INCOME TAX CREDIT REGULATIONS WOULD PROHIBIT HOUSING DEDICATED TO HOUSING THE DISABLED FROM QUALIFYING FOR LOW-INCOME HOUSING TAX CREDITS.
3. LOW-INCOME HOUSING TAX CREDITS EXPIRE AT THE END OF THE YEAR IN WHICH THEY ALLOCATED ALLOWING INSUFFICIENT TIME FOR A NON-PROFIT ORGANIZATION TO DEVELOP A PROJECT AND ATTRACT INVESTORS.

To solve these problems, Common Ground proposes that the law be changed to allow or clarify that:

1. PRIVATE INVESTORS SHALL BE DEEMED TO HAVE ENTERED INTO LOW-INCOME HOUSING VENTURES WITH NON-PROFIT CHARITABLE ORGANIZATIONS "FOR PROFIT", EVEN THOUGH THEY HAVE ENTERED INTO BINDING AGREEMENTS WITH THE NON-PROFIT TO GIVE UP OR TO SELL AT LESS THAN FAIR MARKET VALUE A LOW-INCOME HOUSING PROJECT'S RESIDUAL EQUITY.
2. CORPORATE DONORS TO A POOLED INCOME FUND (WHICH ALLOWS NON-PROFIT CHARITABLE ORGANIZATIONS TO RECEIVE A DONATION OF A PROJECT'S EQUITY) MAY RETAIN AN INCOME INTEREST IN THE FUNDS THEY DONATE FOR INVESTMENT IN LOW-INCOME HOUSING FOR A PERIOD OF YEARS.
3. CLARIFY THAT CONFERENCE COMMITTEE REPORT LANGUAGE SPECIFYING "USE BY THE GENERAL PUBLIC" [p. II-95] WAS NOT INTENDED TO EXCLUDE FROM LOW-INCOME HOUSING TAX CREDIT QUALIFICATION HOUSING DEDICATED TO SERVING PEOPLE AFFLICTED WITH A PARTICULAR DISABILITY.
4. ALLOW NON-PROFIT CHARITABLE CORPORATIONS, AND PERHAPS OTHERS AS WELL, TO CARRY OVER ALLOCATED LOW-INCOME HOUSING TAX CREDITS INTO A SECOND AND THIRD YEAR, IF NECESSARY, TO COMPLETE HOUSING AND HAVE IT READY FOR OCCUPANCY.

Each of these problems and solutions is covered in more detail in the pages that follow. Thank you for your consideration of these corrections. We look forward to working closely with you as you improve this important resource for providing low-income housing. If you wish to discuss Common Ground's proposed changes, please call the undersigned at (206) 461-4500.

Sincerely,

Steve Clagett

Steve Clagett
Executive Director

enclosures

PROBLEM:

NON-PROFIT ORGANIZATIONS WHICH WOULD LIKE TO DEDICATE THE HOUSING THEY PRODUCE TO USE BY LOW-INCOME PEOPLE IN PERPETUITY HAVE VERY FEW WAYS TO DO SO UNDER THE CURRENT TAX CODE WHEN WORKING WITH PRIVATE INVESTMENT CAPITAL.

SOLUTIONS:

1. PRIVATE INVESTORS SHALL BE DEEMED TO HAVE ENTERED INTO LOW-INCOME HOUSING VENTURES WITH NON-PROFIT CHARITABLE ORGANIZATIONS "FOR PROFIT", EVEN THOUGH THEY HAVE ENTERED INTO BINDING AGREEMENTS WITH THE NON-PROFIT TO GIVE UP OR TO SELL AT LESS THAN FAIR MARKET VALUE A LOW-INCOME HOUSING PROJECT'S RESIDUAL EQUITY.

2. CORPORATE DONORS TO A POOLED INCOME FUND (A WAY TO ENSURE THAT NON-PROFIT CHARITABLE ORGANIZATIONS RECEIVE A DONATION OF A PROJECT'S EQUITY) MAY RETAIN AN INCOME INTEREST IN THE FUNDS THEY DONATE FOR INVESTMENT IN LOW-INCOME HOUSING FOR A PERIOD OF YEARS.

DISCUSSION:

The current tax code encourages private investment in low-income housing, but prohibits investors, unless they wish to lose tax benefits, from agreeing, upfront, to give up some or all of the residual value some years out so as to allow that housing to remain available, in perpetuity, to low-income people. On the one hand, the federal government gives up revenue in exchange for investment in low-income housing, but then limits the benefit it receives in return by encouraging or assuming a subsequent sale for the highest and best use, a use which often will not be low-income housing. The Code does this by requiring that investors be engaged in low-income housing "for-profit." This is interpreted to mean that an investor may not give up at the outset its ability to realize the maximize return, through a sale of a housing project's residual value at "fair market value", at some future date.

Most non-profit organizations engaged in producing low-income housing in this era of a reduced federal role in low-income housing are concerned that scarce federal, state, and local low-income housing subsidies be devoted to housing that remains affordable to low-income people in perpetuity. Fifteen years is awfully short in our view. Unfortunately, we believe others will soon better understand our concern as prepayments and expiring contracts of Section 236 loans and other federal subsidy obligations drastically diminish our nation's supply of low-income housing. Non-profit organizations need ways to ensure that housing qualifying for Low-Income Housing Tax Credits in which they participate will remain affordable to low-income people after the tax credit benefits have been exhausted and the required fifteen-year dedication to low-income use has expired. The Tax Code makes it difficult to achieve this.

Under the current Tax Code, non-profit organizations are forced to attempt to lock-in low-income, long-term by roundabout methods. These have included:

Accruing and deferred interest-bearing loans to the non-profit's for-profit partner which pass on zero-cost public subsidy money coming first to the non-profit organization. These are coupled with an option to the non-profit to purchase the project at some future date at its fair market value.

A ground lease from the non-profit to its partnership set to expire so as to force low-prices or an advantageous sale to the non-profit at some date in the future.

Liens on the property which restrict its use to low-income housing, thereby lowering its fair market value

Common Ground urges the Subcommittee to explore the means to allow private investors to give up the residual value of a low-income project to a non-profit partner without losing important tax benefits

POOLED INCOME FUNDS

Common Ground, Eastside Community Development in Indianapolis, and others have found a means to use the Low-Income Housing Tax Credit without having to risk the loss of low-income housing in perpetuity. A non-profit charitable organization can set up a Pooled Income Fund which invests exclusively in low-income housing. Donors contribute to the Fund and receive in return during their lifetime, or that of a designated beneficiary, the benefits that would be derived if they invested directly in that housing. However, a Pooled Income Fund provides that upon the death of the beneficiary, their interest in the fund becomes the property of the non-profit group that established the fund.

Common Ground sees great value in opening this resource to corporations. Several communities such as Boston and Chicago have established elaborate multiple-tiered partnership structures to invest in low-income housing in partnership with non-profits. Unfortunately, the level of complexity and the need for sizeable volumes of projects make such equity funds difficult to establish in smaller communities. Pooled Income Funds appear to offer a very attractive alternative for the latter areas, including Seattle.

Although it is generally accepted that corporations may be donor beneficiaries to Unitrusts and Charitable Remainder Trusts, the IRS has ruled in Revenue Ruling 85-69 that, while corporations may donate to a Pooled Income Fund, "The only limitation in the case of a donor who is not an individual is (1) an inability to retain an income interest in favor of the donor...." Apparently, this ruling is based upon the fact that the Pooled Income Fund legislation I.R.C. Section 642(c)(5) speaks only of a donor retaining a lifetime income interest and corporations do not have lifetimes.

Common Ground urges the Subcommittee to support H.R. 4048 submitted yesterday, March 1, by Representative Barbara Kennelly. The bill contains language that would amend Sectin 642(c)(5) to specify that corporations investing in qualified low-income housing would be deemed to have a life of twenty years for purposes of the Section. This period matches the period allowed corporations donating to Charitable Remainder Trusts.

Pooled Income Funds investing in low-income housing are in their infancy. Common Ground is convinced that they will prove to be a very popular means to achieve acceptable partnerships between non-profits and donated individual and corporate capital.

PROBLEM

PROPOSED LOW-INCOME TAX CREDIT REGULATIONS WOULD PROHIBIT HOUSING DEDICATED TO HOUSING THE DISABLED FROM QUALIFYING FOR LOW-INCOME HOUSING TAX CREDITS.

SOLUTIONS

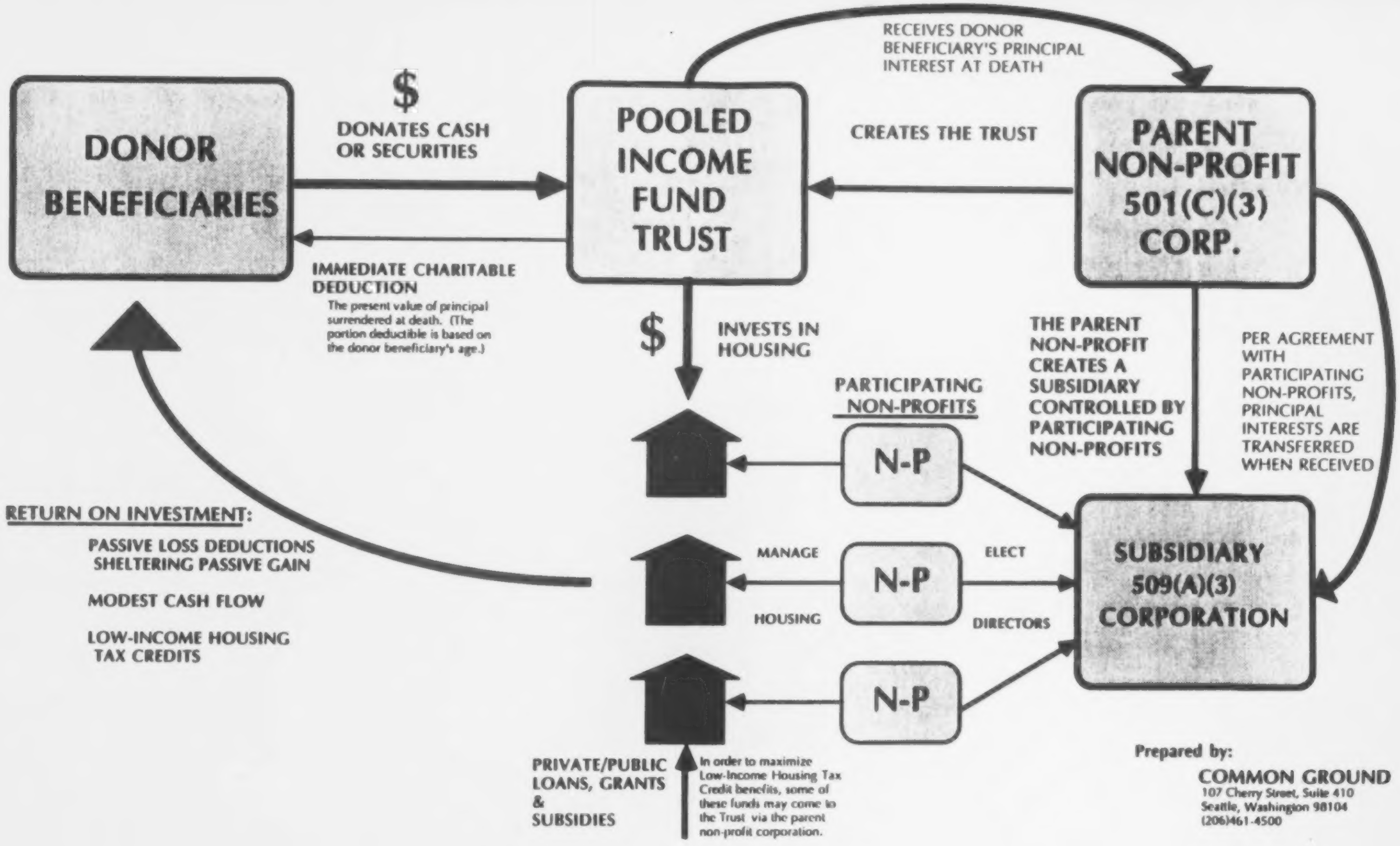
CLARIFY THAT CONFERENCE COMMITTEE REPORT LANGUAGE SPECIFYING "USE BY THE GENERAL PUBLIC" [p. II-95] WAS NOT INTENDED TO EXCLUDE FROM LOW-INCOME HOUSING TAX CREDIT QUALIFICATION HOUSING DEDICATED TO SERVING PEOPLE AFFLICTED WITH A PARTICULAR DISABILITY

DISCUSSION

Common Ground has found that it is very difficult to provide low-income housing for many of today's homeless and ill-housed people without confronting other problems that may have led to or been caused by poverty such as mental illness, developmental disabilities, and alcoholism. It is estimated that 40% of Seattle's downtown homeless population suffer from mental illness. Even housing for the so-called general public, the generic poor, benefits when it can be combined with dedicated programs of employment and counselling. We believe that Low-Income Housing Tax Credit housing should be available to disabled populations and that that housing should be dedicated to those populations when it will help them back to self-sufficiency and independence.

We agree that Tax Credit housing was not intended to include nursing homes or institutions. However, Common Ground has assisted the development of a number of projects that simply were dedicated to a particular special population that might be visited once a week for a housing meeting by a counsellor or where drugs and alcohol were prohibitted to facilitate recovery after more intensive treatment.

Common Ground has learned that the IRS and the Treasury Department favor Low-Income Housing Tax Credit regulations that will disallow housing for the disabled as qualified housing. Common Ground urges the Subcommittee to make clear that it is not the intent of Congress to preclude efforts to provide "housing plus" that serves special populations with more than just a roof over their head.


DONOR
BENEFICIARIES
$
DONATES CASH
OR SECURITIES
POOLED
INCOME
FUND
TRUST
RECEIVES DONOR
BENEFICIARY'S PRINCIPAL
INTEREST AT DEATH
CREATES THE TRUST
PARENT
NON-PROFIT
501(C)(3)
CORP.
IMMEDIATE CHARITABLE
DEDUCTION
The present value of principal surrendered at death. (The portion deductible is based on the donor beneficiary's age.)
$
INVESTS IN
HOUSING
PARTICIPATING
NON-PROFITS
THE PARENT
NON-PROFIT
CREATES A
SUBSIDIARY
CONTROLLED BY
PARTICIPATING
NON-PROFITS
PER AGREEMENT
WITH
PARTICIPATING
NON-PROFITS,
PRINCIPAL
INTERESTS ARE
TRANSFERRED
WHEN RECEIVED
N-P
N-P
N-P
MANAGE
HOUSING
ELECT
DIRECTORS
SUBSIDIARY
509(A)(3)
CORPORATION
RETURN ON INVESTMENT:
PASSIVE LOSS DEDUCTIONS
SHELTERING PASSIVE GAIN
MODEST CASH FLOW
LOW-INCOME HOUSING
TAX CREDITS
PRIVATE/PUBLIC
LOANS, GRANTS
&
SUBSIDIES
In order to maximize Low-Income Housing Tax Credit benefits, some of these funds may come to the Trust via the parent non-profit corporation.

Prepared by:

COMMON GROUND
107 Cherry Street, Suite 410
Seattle, Washington 98104
(206)461-4500

community associations institute

1423 Powhatan Street, Suite 7 • Alexandria, VA 22314 • (703) 548-8600

Marjorie A. Peterson, PCAM®, President
Katharine Rosenberry, President-Elect
C. James Dowden, Executive Vice President

March 15, 1988

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Office Building
Washington, DC 20515

Dear Mr. Leonard:

The Community Associations Institute offers the following statements for the printed record on HR 3663. The Community Associations Institute is a national non-profit membership organization for condominiums, cooperatives and homeowners associations. CAI has over 9,000 corporate members and 43 local chapters around the country. CAI's mission of comprehensive information for all who are involved in creating, operating, and regulating community associations is supported through a wide variety of publications, periodicals, audio cassettes and workshops and seminars.

In general we support the testimony provided by Mr. Terry Lewis, president of the National Association of Housing Cooperatives. But we wish to bring certain other items to the Committee's attention.

Cooperative housing is not the only ownership alternative for low to moderate income families. In 1980, the Community Associations Institute prepared An Action Manual for Housing Ownership and Urban Neighborhoods: An Introduction to Low and Moderate Income Community Associations, under a cooperative agreement (H-2948CA) with the U.S. Department of Housing and Urban Development. This manual sets forth proven mechanisms for utilizing the condominium form and the fee simple homeowners association form in developing and operating limited equity ownership opportunities for low and moderate income families. The Office of Community Investment of the Federal Home Loan Bank Board has documented several non-cooperative forms of low and moderate income ownership housing, such as Shannonwood (Tulsa, Oklahoma), Julius Hobson Plaza (Washington, D.C.), Chestnut Court (Seattle, Washington), La Solana Condominiums (Hayward, California), and others.

Working to Improve Condominium, Cooperative and Homeowner Associations

CAI urges that the benefits and incentives of HR 3663 be extended to qualified condominiums and homeowner associations. Like cooperatives, condominiums and homeowner associations are potentially subject to Section 277 of the Internal Revenue Code. If HR 3663 is broadened to eliminate cooperatives from the coverage of Section 277, we ask that condominiums and homeowner associations be afforded the same benefit.

Condominiums and homeowner associations share with cooperatives the concern that interest on permanent reserve funds not be taxed as non-member income, because such taxation only increases the difficulty which all community associations have in establishing and maintaining adequate reserves for the future repair and replacement of major physical components of their buildings.

It would benefit condominiums and homeowner associations, as well as cooperatives, if government subsidies and grants are clarified to be member income.

Finally, I wish to point out the tax inequities under Section 528. Condominiums and homeowner associations have been subject to a 30 percent flat tax rate since 1980, despite the reduction in individual and corporate rates in 1986. As a result, nearly half of the community associations responding to a CAI Research Foundation questionnaire in 1987 reported that they file form 1120, instead of form 1120-H, in order to gain the benefit of lower corporate tax rates available through that filing. We believe that if the tax rate under Section 528 were lowered to, say 21 percent, many associations would switch back to the 1120-H form which is simpler for them to fill out and simpler for IRS to process. Indeed, given the market today, some associations that file form 1120-H have invested their funds in tax-exempt bonds because the difference in yields is offset by the potential of a 30 percent tax rate.

If it is not possible for the Committee to address the issue of a rate change for Section 528 through HR 3663, we urge the Committee to consider such a rate change in subsequent tax legislation and correct the current inequity.

Respectfully yours,

James Dowden

C. James Dowden
Executive Vice President

Statement of F.McDonald Ervin
President
Covenant Development Corporation
Before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives

March 14, 1988

Mr. Chairman and Members of the Subcommittee:

I thank you for this opportunity to present the following comments on H.R. 3663. Covenant Development Corporation supports legislation which seeks to preserve the stock of low income houising. We believe that such housing is best organized and operated on a cooperative basis; however, such organization and operation is threatened if large amounts of income are taxed at a high corporate rate.

The immediate problem is taxation of income from "non-member"sources separtely from income from "member" sources, as if members of a cooperative can realize a benefit from the income from the "non-member" sources. In fact the only benefit, if such income is integrated with other income, is the benefit of cooperative housing, which is the single benefit which a cooperative housing association is established to provide.

The singleness of purpose of income to a housing cooperative- to preserve the housing differentiates the housing cooperative from a social club. The latter may have income from dues and also income from investments, which are not necessarily integral to its purpose.

The use of interest on the invested reserves of a housing cooperative illustrates the point of difference. Interest, when added to the reserves, helps insure the adequacy of the reserves for future use, by providing a cushion against inflation, and a contingency fund as a cushion against unexpected costs.

There is a method of financial management which members of a cooperative may take. It uses the income from invested reserves to defray the cost of contribution to those reserves. This method is different from the use of interest just described. The second method may make the income taxable. It more closely corresponds with financial management in a social club.

Section 277 does not differentiate between prudent management, which integrates all income for the maintenance of the cooperatives, and income which is partly for the benefit of members.

Reference to Section 277 in H.R. 3663 should be deleted. The bill, which we hope will become law, should more fairly treat taxation of cooperatives by allowing Subchapter T of the Internal Revenue Code to govern taxation of housing cooperatives' income. Such a method of taxation will allow developers of low income housing to plan accordingly, and allow plans to be implemented without threat of taxation of income which at best only covers the cost of housing

STATEMENT OF ROBERT GORDON
PRESIDENT
EAST MIDTOWN HOUSING COMPANY, INC.
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

March 14, 1988

Honorable Mr. Chairman &
Members of the Sub-Committee:

I am the President of East Midtown Plaza Housing Company, Inc. ("EMP"). The EMP cooperative is located on the block bounded by East 23rd Street and First and Second Avenues in the Borough of Manhattan, New York. It's office address is 319 East 24th Street, New York, New York. EMP is a low and moderate income housing cooperative organized under the New York Private Finance Law and whose mortgage is insured by the Secretary of the Department of Housing and Urban Development under the provisions of section 223f of the National Housing Act. I believe the experiences of EMP may be instructive to the members of your subcommittee as they have particular reference to sections 5 and 6 of proposed HR3663, and I thank you for the opportunity of sharing them with you.

I speak for all 746 cooperative families at EMP (and I am sure for all other cooperators similarly situated) in thanking Chairman Rangel and the other subcommittee members for seeking to preserve and augment housing opportunities for low and moderate income families.

DISCUSSION

EMP was created under the provisions of the New York Private Housing Finance Law some 17 years ago with subsidy assistance of the City of New York, to house low and moderate income families. Some 8 years ago it refinanced it's underlying mortgage so that its mortgage holders were afforded mortgage insurance under the National Housing Act. Accordingly, it is required to maintain in accordance with a regulatory agreement substantial replacement reserves mandated by the mortgage documents.

EMP was constructed on a site acquired by the City of New York under a Urban Renewal Plan which the City financed with federal funds again, under the National Housing Act. It's development into the present cooperative included income limitations, provisions for the rehousing in EMP of individuals displaced by the Urban Renewal Program, and provision for the creation of commercial store space the priority of occupancy of which, had to be granted to commercial businesses displaced by the Urban Renewal Program.

In the past two years the Internal Revenue Service has commenced an audit of EMP's tax returns for the 1982 through 1985 fiscal years. The service within the past month advised EMP that for the years in question it is in deficiency in tax payments on the order of $1,245,000.00.

The Service findings relate to section 277 of the Internal Revenue Code and assert that under the Code, income that EMP received from interest on its reserves (substantial portions of which are mandated by the Federal Government) are taxable; and that income that EMP receives from its commercial store space (mandated by the governmental authorities that fostered EMP's development, and supervise it) is taxable. In addition, the Service claimed that EMP is also taxable on income derived from the excess of the interest paid by EMP to its mortgage holder (an agency of the City of New York) over the interest received from the mortgage holder on the bonds the agency issued and which are secured by the mortgage. That differential is not received by EMP, rather it is applied against debt service payable by EMP on a subordinate mortgage held by the City of New York.

Based therefore on the Service contention that Section 277 of the Code applies to cooperative housing companies, the Service asserted that for the tax years from 1982 through 1985 EMP owes in additional tax in excess of $1,245,000.00 which, with interest is estimated to exceed $1,500,000.00.

If the Service position is upheld, (and EMP intends to contest that position vigorously) the consequences will occasion a rent increase that the cooperators of EMP shall have to face of some 45% of present rent (maintenance) to defray the expense of the claimed deficency, and an annual further increase of approximately 12 to 15 percent to cover claimed taxes for each ensuing year.

EMP cooperative families like others in similar governmental housing programs are required to resell their apartments when they vacate EMP at essentially the price they paid for them. Thus, the governmental programs under which EMP was built prohibits resale by a cooperator at a profit. The rents EMP charges its cooperators are similarly regulated and of course EMP as a cooperative generates no profits. Its reserves are in part mandated by the governmental programs under which it operates, and those reserves it maintains under prudent management principles, are maintained specifically to provide for a means for replacing it's physical plant over time. The reserves it invests, generate interest and the earnings of the reserves permit EMP to avoid assessing its low and moderate income cooperators for needed replacement work or borrowing funds which would increase rent to cover the debt service of such borrowed funds.

EMP generates commercial income as mandated by its governmental sponsors in order to provide neighborhood shopping for its cooperators; to further offset the cost of housing it's low and moderate income inhabitants and; was created with commercial store space under governmental mandate to place relocated merchants in such spaces pursuant to the governmental program seeking to alleviate the consequences of site clearance.

I submit to the Members of the subcommittee that the experience of EMP is particularly relevant in the Members consideration of HR3663. Our cooperators and their families are already struggling to to defray the monthly maintenance charges that they must pay to EMP. The position of the Internal Revenue Service if it is upheld, will doubtless make it impossible for many of our families to meet the increased expense of EMP apartments. Utilizing those of EMP's reserves as may be used for operational needs, to pay the taxes the Service would impose would denude this cooperative of needed funds for future maintenance and replacement. Further borrowing to meet the Internal Revenue Service claims would obviously increase further, maintenance charges to defray debt service costs. Application by the Service of Code section 277 to EMP and similar cooperatives would thus wreak havoc with the salutary government purposes which all levels of local and the federal government have combined to accomplish, the housing of low and moderate income families.

Under the terms of EMP's mortgage documents, and under present law, EMP can elect to repay its mortgage indebtedness and be relieved of governmental regulations as to maintenance or rent levels, and non-profitability some 20 years after it was created. Thus, within three years, EMP would have the opportunity of determining whether its limited profit, limited equity position would continue or, end. The escalation of maintenance levels compelled by the position of the Internal Revenue Service and the additional tax expense visited upon EMP will be great. Cooperators whose rent levels will be forced higher, to defray the additional income taxes assessed by the Service will, for their economic well being have to consider the option of freeing EMP from regulation. If they are unable to defray the increased rent and would thus have to vacate their apartments, they would have to consider the desirability of resale of their apartments on the free market, free of regulation, as a desirable alternative to vacating their apartments because they cannot afford to pay the rent. Thus it is feasible that the Internal Revenue Service may compel the termination of the very class of housing your subcommittee is valiantly seeking to foster and preserve.

RELIEF REQUESTED

We appeal to members of the subcommittee to adopt a measure that would determine that section 277 is inapplicable to the types of income described above for low and moderate income housing cooperatives, even if the Courts ultimately hold that section 277 does apply to such cooperatives. Of course the legislation should indicate no inference is to be drawn from the adoption of the proposed legislation as to the applicability of section 277 of the Code to housing cooperatives.

* * *

On behalf of the 746 families of the East Midtown Plaza cooperative, I thank you for your concern for continuation of successful programs for affordable housing for low and moderate income families and, urge you to support legislation that will permit its continuation.

Respectfully Submitted:

EAST MIDTOWN HOUSING
COMPANY, INC.

By: ____________________
Robert Gordon, President

HERBERT H. FISHER
ATTORNEY AT LAW

SUITE 1000
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COMMITTEE ON
RECEIVED
MAR 18 1988
WAYS AND MEANS

March 7, 1988

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

RE: HR 3663

Dear Mr. Leonard:

Please provide the Committee on Ways and Means and to its Subcommittee on Select Revenue Measures this communication.

I am an attorney with 36 years of active practice experience in Milwaukee, Wisconsin and Chicago, Illinois. For the past 26 years I have been involved as a participant and an attorney in cooperative housing. Both my own experience as well as statistics available through the Department of Housing and Urban Development substantiate that the cooperative housing form of ownership provides the most stable and well maintained properties of all of the HUD programs for families of all income levels. Unlike other forms of home ownership, its successful experience is shared by all income level families from the cooperators to the high income cooperative shareholders, all sharing one common experience and goal: the perpetuation of democractically operated cooperative communities providing well maintained housing in accordance with its owners' abilities and means.

Assistance in avoiding undue burdens which have no or little significance in the revenue generating abilities of our Internal Revenue Code deserves favorable attention to these simple and basically non-controversial requests.

HR 3663 should provide that Section 277 of Internal Revenue Code relating to social membership organizations is not applicable to cooperative housing corporations as defined in Section 216 of the Internal Revenue Code.

It should further define as member or patronage source income or income earned or received to facilitate the principal purpose of the cooperative as the following:

A. Government subsidies (such as Section 8 housing assistance) and grants;

B. Insurance proceeds which are placed in a reserve for repair or improvement of the property;

C. Interest on mortgagee, mortgage insurer or governmental agency and other reasonable reserves and escrows related to the required principal purpose of the cooperative housing corporation;

D. Commercial income in Cooperatives housing low and moderate income families.

The bill should also utilize a principal purpose test in place of the 80-20 test.

Very truly yours,

Herbert H. Fisher

HHF.i

Honorable Bill Green

A Representative from the State of New York

March 1988

Mr. Chairman and Members of the House Committee on Ways and Means, thank you for the opportunity to offer some comments on HR 3663, a bill to amend the Internal Revenue code of 1986 to provide incentives to prevent the loss of low-income housing stock. There are several key provisions in this bill which concern housing cooperatives which I should like to address.

As a Member of Congress with a large number of housing cooperatives in his district, I am concerned that this bill, by providing relief only to limited-equity housing cooperatives as defined by the Tax Reform Act of 1986, is too limited in scope. I strongly believe that it would be a mistake to divide our forces with a bill which is exclusively limited to low income housing. We must not forget the much larger group of housing cooperatives which is also confronting the adverse tax consequences of the application of Section 277 of the Internal Revenue Code and the 80/20 income requirement of Section 216. Let me explore these two concerns more specifically.

First, as you know, current Federal law permits a co-op "tenant-shareholder" to deduct from federal income tax returns his proportionate share of the corporation's expenses for interest and real estate taxes only if commercial revenue totals no more than 20% of the corporation's gross income. No stockholder is permitted to receive any distribution not out of earnings and profits, except in the case of liquidation. Thus, at least 80% of the gross income for the taxable year must be derived from "tenant-stockholders," as defined by the code. I do not think we are well-served by exempting only limited-equity housing co-ops from the 80/20 income rule such as is proposed in HR 3663. I believe that at a minimum the application of the 80/20 test should be modified, or preferably repealed and replaced with a principal purpose test for all housing cooperatives. In many parts of the country it is normal for apartment housing to contain professional offices or retail establishments; there appears to be no reason to penalize co-ops that follow that normal practise. In some cases, housing co-ops have had to hold commercial or professional rents artificially low to meet the 80/20 test, surely a result unanticipated by the drafters of Section 216.

Second, there has been a great deal of debate as to whether Section 277 applies to housing cooperatives. As you know, Section 277 was enacted by the Congress in 1969 and was intended to apply to social clubs and other membership associations. It provides that such organizations may be required to pay taxes on income that is defined by the IRS to have no relationship to the organizations' primary purpose. In the last several years, however, the IRS has increasingly sought to broaden the definition of what organizations are included in the phrase "membership associations," and has included residential associations and cooperative housing organizations in that category. In recent years many cooperatives have come under audit for application of Section 277. In view of the specific applicability of Section 216 to housing co-ops, application of Section 277 is unwarranted, and Congress should make that clear.

In conclusion, while there are special problems applicable to certain government assisted co-ops, the 80/20 problem and the Section 277 problem apply to all housing co-ops and should be dealt with as to all of them.

GREENBELT HOMES, INC.
HAMILTON PLACE, GREENBELT, MARYLAND 20770
Area Code 301 474-4161

March 3, 1988

The Honorable Charles B. Rangel
Chairman, Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Building
Washington, DC 20515

Dear Chairman Rangel:

We are submitting a written statement for the record of the public hearings on March 2 and 3, 1988, concerning the role of the tax policy in preserving the stock of low income housing. This statement is pursuant to instructions contained in your press release #8 dated Wednesday, February 10, 1988.

Greenbelt Homes, Inc. is a 1,600 unit member-owned, not-for-profit housing cooperative which was founded in 1953 through a conversion of homes developed by the United States Public Housing Administration. G.H.I. has a rather diverse membership with a broad spectrum of incomes. However, the majority would be classified as moderate to middle income persons. The cooperative is home to a significant number of senior citizens, single parents, and low-income families.

We have reviewed House of Representatives Bill #3663 entitled the "Low Income Housing Tax Act of 1987". As one of the largest providers of home ownership opportunities for low and moderate income families in the Washington area, we support enactment of H.R.3663, which will help to preserve the limited stock of low income housing that presently exists. Few initiatives have surfaced during the last eight years to preserve affordable housing. Many actions have been taken to reduce or eliminate programs that formerly produced such housing. Enactment of H.R.3663 should help stem the attrition of this scarce and valuable resource. If this legislation is not enacted, the displacement which would result from lifting the restrictions on housing developed under Section 221(d)4 could be severe.

G.H.I. is a market equity cooperative and would receive no benefit from Sections V and VI of H.R.3663. However, we belong to a regional association -- the Eastern Cooperative Housing Organization (ECHO) -- which contains many limited equity cooperatives, as does the National Cooperative Business Association, of which we are a member. Our observation is that limited equity housing cooperatives provide a unique opportunity for families of low and moderate income to attain the benefits of home ownership. Due to cost constraints, the private sector is unable to offer such ownership opportunities to these families. The limited equity principle preserves these cooperatives as affordable housing for future generations. Enactment of Section VI of the bill would assist such cooperatives to retain adequate reserve funds to meet their goal of providing a permanent low and moderate income housing resource.

The dwelling units which comprise Greenbelt Homes were constructed in 1937 and 1941. Greenbelt marked its 50th Anniversary in 1987. We, and the other ECHO coops (which are of similar vintage) have devoted considerable effort in analyzing the necessity of establishing reserve funds to ensure timely replacement of building components in order to make our cooperatives last another 50 years. In the early 1980's, Greenbelt Homes borrowed approximately $18 million dollars to fund a comprehensive rehabilitation of our community. Needless to say, we will be paying interest on those funds for the next 20 years (and our members will be deducting that interest from their income taxes). G.H.I. does not want to repeat this process within the next 50 years. Our Board of Directors has adopted a policy whereby we will save the necessary reserves to avoid such future borrowing. Other ECHO coops discussed this at our annual conference and have begun a similar planning process.

Too often in the history of the United States housing has been viewed as a disposable commodity. The current budget pressures at the federal, state, and local level mandate that we maximize the effective life of all of America's housing resources, particularly if we are to meet the goal of the 1937 Housing Act of "providing a decent home for every American". A decision to tax the interest income earned on reserve funds, which income could otherwise be used for the purpose of the reserve, would contradict these efforts to meet the stated purposes of America's housing policy.

The policy contained in Section VI of H.R.3663 is the most cost effective means available to preserve America's affordable housing stock. For this reason, we would not be adverse to expanding the scope of the bill to treat interest on mandatory and reasonable reserves and escrows for all housing cooperatives as member income under Section 216 of the Internal Revenue Code.

We would also encourage enactment of a technical amendment which would clarify that insurance proceeds from residential property, which would be reinvested or placed in a reserve for the property's repair or improvement, should be classified as member income under Internal Revenue Code Section 216.

Some members of our community receive rental assistance under Section VIII of the United States Housing Act and similar programs. These programs provide a valuable service in enabling low and moderate income persons to reside in communities such as Greenbelt. We pride ourselves on the diverse socioeconomic makeup of our community. We, like other coops, would appreciate it if the bill could be amended to clarify that such government subsidies and/or grants are member income under I.R.C. Section 216. G.H.I. makes no distinction whether monthly cooperative fees (carrying charges) are received directly from the member or through an assistance program such as Section VIII. This is as the government intended, and such a clarifying amendment would only confirm that fact.

We thank the Committee for the opportunity to submit this statement for the hearing record. The last eight years have witnessed the retrenchment and, in some cases, total dismantling of many of the federal housing programs which contributed to a dramatic improvement in the nation's housing stock over the last 50 years -- an improvement which was unprecedented in the annals of western civilization. Greenbelt Homes and our sister cooperatives in ECHO were constructed as a means of implementing America's housing policy which was first set forth in the National Housing Act of 1937. We view H.R.3663, the Low Income Housing Act of 1987, as a step to preserve the gains which were made over the last 50 years. We hope the Committee reports favorably on this much needed legislation and that it will be adopted by the House and Senate.

Please feel free to call upon us if we can provide any additional information or supporting documentation.

Sincerely,

Margaret Hogensen

Margaret Hogensen
President

Ronald Colton

Ronald Colton
General Manager

FRANK J. GUARINI
14TH DISTRICT
NEW JERSEY

COMMITTEE ON WAYS AND MEANS

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March 17, 1988

Hon. Dan Rostenkowski
Committee on Ways & Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

I am writing to request that the enclosed report entitled "The Preservation of Low and Moderate Income Housing in the United States of America," be included in the hearing record on low income housing which was recently held by the Select Revenue Measures Subcommittee.

Thank you for your assistance in this matter.

With kindest regards,

Sincerely,

Frank

FRANK J. GUARINI
Member of Congress

FJG:sc
Enclosure

THE PRESERVATION OF LOW AND MODERATE INCOME HOUSING IN THE UNITED STATES OF AMERICA

A REPORT BY THE
NATIONAL HOUSING PRESERVATION TASK FORCE

THE NATIONAL HOUSING PRESERVATION TASK FORCE

1625 Eye Street, NW—Suite 1015
Washington, DC 20006

February 15, 1988

Mr. Daniel C. Grady
Chairman
The National Advisory Council of
HUD Management Agents
1625 Eye Street, NW
Suite 1015
Washington, DC 20006

Dear Mr. Grady:

It is an extreme pleasure to forward to you under cover of this letter the Report of the National Housing Preservation Task Force on the preservation of low and moderate income housing for the United States of America.

This Report is in response to action taken by The National Advisory Council of HUD Management Agents in March 1987 to sponsor a task force that would address the serious national problem of a potential loss of the inventory of privately owned assisted housing presently serving families of low and moderate income in the United States. The findings that would result from this effort would be furnished as a report to the Council for its presentation to the United States Congress as recommended solutions to the problem.

This task force was to be representative of the assisted multifamily housing industry nationally, with its select membership reflecting the collective experience of those engaged first hand in tenant advocacy, state and local government, management, ownership, finance and the legal profession.

As you know, this did lead to the establishment of the National Housing Preservation Task Force, as intended. Since its first meeting in April 1987, the membership of this Task Force has worked diligently on the complex social and financial issues that surround the problem. Throughout, there has been a strong concern for objectivity and for the need to establish responsible positions that are in the best interests of the United States of America. It is trusted that the results of this effort, as contained in the attached Report, will be found consistent with those concerns.

The membership of the Task Force joins me in expressing our appreciation to the National Advisory Council for the opportunity to contribute to a solution of this serious problem and wishes also to compliment the Council on its splendid initiative to address the problem so directly.

Sincerely yours,

G. Lindsay Crump

G. Lindsay Crump, *CPM*
General Chairman
National Housing Preservation Task Force

FOREWORD

The supply of affordable housing for low and moderate income households of the United States is an increasingly serious national problem.

While the gap between supply and demand for this housing has been increasing, the problem may soon reach crisis proportions because the present inventory of privately owned, assisted housing is being threatened by expiring Federal and private commitments along with an absence of any affirmative Federal action to maintain and expand the low and moderate income housing stock.

In response to this national dilemma the National Housing Preservation Task Force has come together, under the sponsorship of the National Advisory Council of HUD Management Agents, with a mandate to examine the problem and to provide recommended actions.

Membership of the Task Force has been comprised of twenty-seven leading experts drawn from a broad spectrum of interests in multifamily rental housing, with extensive experience in property management, ownership, tenant interests, the legal profession and the administration of government programs.

In carrying out its mission, the Task Force has focused on the preservation of the existing inventory, leaving to others the important task of determining how additional affordable housing should best be provided. The Task Force has convened repeatedly since April 29, 1987 in the form of six committees and in full session. It has had the encouragement of the Department of Housing and Urban Development and of the staffs of the Subcommittee on Housing and Urban Affairs of the Senate Banking, Housing and Urban Affairs Committee, and the Subcommittee on Housing and Community Development of the House Banking, Finance and Urban Affairs Committee, as well as the assistance of the staff of the National Advisory Council.

This Report is the product of that work. It has been developed with sincerity of purpose and has been motivated by a deep concern for an adequate supply of affordable shelter for low and moderate income Americans. The conclusions and recommendations it contains are believed to be in the collective best interests of all Americans.

This Report reflects the consensus of the diverse views of the members of the Task Force. Although there were differences among the members of the Task Force on individual issues and no individual member necessarily endorses every recommendation, no minority report has been drafted because we were able to reach broad areas of agreement on these important matters. This Report is the product of the individuals who served on the Task Force and does not represent the position of any organization or institution with whom those individuals may be associated.

The Task Force recognizes that many of its recommendations will require changes to existing statutes along with, in many instances, specific action in appropriations bills. It urges the Administration to endorse the necessary statutory changes and to seek enactment of those changes this year. It further urges that the HUD budget request for FY 1989 be revised to include the additional funding called for in this Report. Congress is urged, then, to enact these statutory changes and take the necessary appropriations actions.

At about the time the work of the Task Force was concluding, the Housing and Community Development Act of 1987 was given final approval by the Congress. We commend the Congress for this action and the President for his recent signature of this important legislation. The Task Force did not have an opportunity to consider the final provisions of the 1987 Act but it does applaud the Congress' recognition of the major threat to the nation's supply of low and moderate income housing posed by impending mortgage prepayments and expiring housing subsidies. We trust that the recommendations contained in this Report will assist the Congress to take the next step toward resolving these matters on a permanent basis.

G. Lindsay Crump

G. Lindsay Crump, CPM
Chairman
National Housing Preservation Task Force

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EXECUTIVE SUMMARY

The Problem

The Report addresses the serious national problem of the potential loss by the year 2000 of a very substantial portion of the existing inventory of privately owned, assisted rental housing for the low and moderate income. This loss would start occurring at the same time that the supply of affordable housing, in general, is becoming increasingly short.

While the Task Force's study has revealed a complex involvement of legal and social issues, conflicting perspectives among the principal parties, and ultimate public obligations that are fundamental to the success of any proposed solutions, the dimensions of the problem are clear. They are:

- The potential loss from the existing inventory is between 1.2 million and 1.5 million units by 1995 and over 1.8 million units by 2000.
- While most attention has focused on the potential loss from the inventory as the result of mortgage prepayments, much greater losses will occur as the result of expiring Section 8 contracts.
- The number of units in 221(d)(3) and 236 projects lost through prepayment could be sharply increased as the result of the expiration of project-based, rent-subsidy contracts and the lack of funds for capital repairs and improvements.
- Notwithstanding the necessary participation of the tenants and the owners in achieving solutions, the Federal Government must accept the major responsibility for positive remedial action if solutions are to be found.

A re-establishment of the public/private partnership that created this housing is necessary to create a workable environment for the solutions being proposed.

Only through such a reestablishment can the sometimes conflicting positions of owners, tenants and the various levels of government be brought together to assure that:

- the obligation of the Federal Government to preserve the existing inventory of low and moderate income housing is reaffirmed,
- the contractual rights of the owners are protected, and
- every existing low or moderate income tenant of a project whose mortgage is prepaid is provided continuing, affordable shelter.

A Measurement of the Problem

The existing inventory of privately owned, low and moderate income housing consists of approximately 2 million units receiving assistance in specific projects (project-based) and about 960,000 units occupied by tenants receiving assistance under the Section 8 certificate or voucher programs (tenant-based).

The threat to this inventory arises in three principal areas:

1. ***The Prepayment of Mortgages***—When the mortgage is paid off on a HUD-assisted project, HUD's controls over that project cease, such as those limiting occupancy to low and moderate income tenants. Also, the favorable financing, which is the subsidy for 221(d)(3) BMIR and 236 projects, ceases. According to HUD—

- 360,000 units, out of the total 604,000 units in 221(d)(3) and 236 projects with mortgages insured or held by HUD, are eligible to be prepaid after 20 years
- the remaining units are in projects (nonprofits, cooperatives and projects receiving rent supplement assistance) whose mortgages cannot be prepaid without HUD approval
- by 1995, prepayment-eligible mortgages covering 316,000 units will have attained 20 years
- total prepayments are expected not to exceed about 154,000 units because of such factors as project location, physical condition of the project, owner preferences and restraints imposed in connection with other subsidies provided the project.

The Task Force estimates that total prepayments should be below 100,000 units and could go to as low as 50,000 units, provided proper incentives are provided to owners.

The Task Force believes that prepayments of FmHA Section 515 mortgages and state-financed 236 mortgages should both be minimal.

2. Expiring Subsidies—Rental subsidies under the several Section 8 programs are available for specific time periods, generally shorter than the 30 to 50 year terms of project mortgages. These terms are 5 years for vouchers; 15 years for loan management setasides (LMSA), moderate rehabilitation and certificates; and 20 years (common) to 40 years (rare) for new construction and substantial rehabilitation. These terms cannot be extended without statutory change in some cases and without significant Federal budgetary impact in all cases. The present distribution of these subsidies is:

- 280,000 LMSA units presently assist almost one-half of the inventory of 221(d)(3) and 236 units; the contracts on at least 100,000 of these units will expire by 1995 and almost all will have expired by 2000; these expirations will seriously jeopardize the financial stability of 221(d)(3) and 236 projects
- over 700,000 units are receiving Section 8 assistance in newly constructed or substantially rehabilitated projects; these contracts will start expiring in 1996, with 200,000 units off subsidy by 2000; 180,000 of those 200,000 units could be removed from subsidy by 1994, if owners elect not to renew contracts at the end of their second or third five-year terms
- over 100,000 units are in Section 8 moderate rehabilitation projects; contracts on 90,000 units will have expired by 2000
- over 960,000 units are occupied by tenants using Section 8 certificates or vouchers; contracts on at least 636,000 of these units will have expired by 1995, with almost all of the remainder expired by 2000.

3. Physical Condition—About 33 percent of all older, HUD multifamily projects have high repair needs or very little cash flow to meet ordinary repair needs. This percentage is believed to be higher in low and moderate income projects, and the lack of funds to meet increasing capital replacement and improvement needs in these projects is expected to lead to both increased mortgage defaults and mortgage prepayments.

The losses to the inventory of low and moderate income housing, through both prepayments and expiring subsidies, could start occurring in significant amounts in 1989 and by 1991 could exceed 200,000 units per year. As this starts to occur, there is little likelihood of any change from the present situation, which finds the gap between the supply of housing for the low and moderate income and the need for such housing being at its widest in many years. This has been exemplified by significant increases in low-income households, millions of whom are paying over 60 percent of their income for rent, and the estimated 700,000 homeless, many of them families with children.

While this gap has been widening, the Federal Government has been making sharp cuts in its low and moderate income housing programs and removed most tax incentives for owning such housing with enactment of the Tax Reform Act of 1986. It, further, has made no plans to deal with the impending losses from the inventory, let alone meet the nation's other growing low and moderate income housing needs.

The Conflict of Perspectives

During its eight-month study, the Task Force dealt continually with the conflicting positions of the tenants, the owners and the Federal Government. Only by returning to the fundamental reasons why the housing was created could these conflicts be put into a basic perspective from which the Task Force itself could function effectively.

From that basic perspective there is much evidence that the housing has worked generally as intended. At this point, the government has met a public obligation by providing the housing; many millions of persons have enjoyed affordable housing that otherwise would not have been available; and owners have had an opportunity to realize their varying financial and/or social objectives.

Still, separate, conflicting perspectives of the parties do exist:

- Residents of the existing stock know that they may have no place to go if their present housing becomes unaffordable. Therefore, they feel that they must be guaranteed a continuation of affordable shelter.

- The owners believe that there is a clear contractual right to prepay their mortgage and change the use of the project, without any continuing financial obligation to subsidize the rent of their present tenants. The owners also believe that so long as Federal constraints continue on use and on the manner of project operations, the Federal Government has an obligation to provide a renewal of rent subsidy contracts if that subsidy support is critical to the continued viability of a project.
- The Administration's position on low and moderate income housing is generally at odds with the concerns of both tenants and owners. These differences are:

Owner-tenant concerns	**Administration's Position**
A widening gap is occurring between the supply of and the demand for affordable housing.	The question is only one of affordability, not supply.
Long-term, project-based rent subsidy is essential to continued project viability.	Short-term housing vouchers provide an acceptable substitute for project-based subsidy.
The tenant is concerned about displacement for any reason in a tight housing market.	Housing vouchers will satisfy the problem.
The need for low-cost, capital-improvement funds is serious and growing.	No active support for such funds.

The nature of the ownership of assisted housing further complicates the problem. The majority of project ownership interest is in the hands of passive, limited-partner investors, who purchased those interests solely for business reasons. Owners of these projects are now faced with expiring tax benefits, phantom income (taxable income in excess of cash flow) and questionable project residual values due to the effects of the Tax Reform Act of 1986. At the same time, the need for capital repairs is growing while project cash flow is limited.

This is the context in which an owner must decide a project's future course when its mortgage becomes eligible for prepayment. When that decision is to be made by a limited partnership's general partner, the limited-partner investors will expect it to be made in a business-like fashion in keeping with the general partner's fiduciary obligation to them.

Conclusions

Every reasonable effort must be made to preserve the existing stock of privately owned, low and moderate income housing.

For these efforts to be productive, it is essential that there be a revitalization of the earlier public/private partnership. The Federal Government should serve as the convener of this revitalized partnership. In turn, state and local governments and private owners must actively work with the Federal Government.

While the solutions must be individually structured to fit the unique circumstances of each project, they should all fall within one or more of the following three categories:

- incentives to induce owners to retain their projects' low and moderate income character
- long-term renewal of project-based, rent-subsidy contracts
- low-interest loans for project repairs and improvements.

All tenants should pay a fair share of their income for rent.

Preventive action taken should be of a long-term nature.

Owners should take into consideration the needs of their tenants and should be responsive to offers of governmental incentives to deter prepayment.

Specific Recommendations

1. The Prepayment Issue

In making decisions on the prepayment issue, the Task Force recommends that the following principles guide the actions of the parties involved.

a. Basic Precepts

(1) The owner has a clear contractual right to prepay and to use the property for other purposes, unless prohibited by other contracts.

(2) Low and moderate income tenants of the existing inventory of privately

owned, assisted housing should be provided continuing, affordable shelter of at least comparable quality and cost, in the event the tenant's unit is lost to the inventory due to prepayment.

(3) In the event of prepayment, the tenant should be permitted to remain in place at no increase in rental cost to the tenant, except for regulatory reasons, until replacement housing of comparable cost and quality is available.

(4) It is the obligation of the Federal Government to provide this affordable replacement housing, as well as Section 8 rental assistance, as long as a tenant remains in the project pursuant to the preceding paragraph. The Government should also accommodate any relocation costs that might occur.

b. Estimates of Inventory Loss

These estimates should be based on the prepayment problem being dealt with realistically and in a timely fashion and after taking into consideration the following factors:

- Many owners would choose to remain in place if appropriate benefits and a suitable operating environment are provided.
- The cost of conversion to market-rate rental operation could be prohibitive in terms of physical improvements, expenses and potential tenant unrest.
- Many markets could not sustain the sizeable rent increase that would be necessary to accommodate expanded debt service and capital improvements.

c. Market Value

The market value of a project should be used by HUD as a basic guide to determine the level of incentives, if any, that should be offered by HUD in endeavoring to persuade an owner to retain the low and moderate income character of a project.

As soon as possible but in any event no later than the seventeenth anniversary of final endorsement, every project should be appraised to determine its market value at its highest and best use—absent of any regulatory constraints and/or any rent subsidy.

This market value should be compared to the replacement cost of building similar projects, at the same time as the appraisal, on available land in the same market area. The difference between the market value and the loan balance should be calculated so as to determine the amount of "locked-in" or imputed equity.

d. Housing Vouchers as Displacement Assistance

In areas of tight housing supply, vouchers should be supplemented with a relocation benefit that, together with the voucher allowance, will enable a displaced tenant to afford to pay true market rent.

2. Incentives to Owners

The incentive or combinations of incentives offered to a project owner should be based on the specific characteristics of that project, including its market value and replacement cost, market area, location, design, physical condition, tenant profile and the requirements of its ownership.

Negotiations with owners whose mortgages will be eligible for prepayment should begin no later than three years prior to the date of the project's twentieth anniversary, in order that the problem can be addressed in an orderly, cost-effective manner. This will require some 900 projects containing over 100,000 units to be addressed during 1988, in order that potential prepayments through 1991 may be dealt with in a timely fashion.

Any rent increase necessitated by the use of one or more of the suggested incentives should be phased-in, so as to assure that no unit's rent increases by more than 10% over the previous year's rent, in addition to any increase required to cover increased operating expenses. Where the incentive increase would cause the tenant's portion of the rent to exceed 30% of income, extra rental subsidy should be provided by the Federal Government.

Incentives can take different forms:

a. Financial Incentives

(1) An Increase in Allowable Distributions

The difference between appraised value and the existing mortgage balance would be the new imputed equity on which the allowed 6% return on investment would be applied.

(2) Recovery of Accumulated Equity

Secondary financing, based on value and ability to service the debt, should be permitted in order to release part of the locked-in equity.

The amount to be borrowed should be limited to the greater of $15,000 per unit, or an amount based on debt service that could be met by rents not exceeding 30% of 80% of the area median income.

(3) Low Interest Loans for Capital Improvements

HUD, as part of its management oversight responsibility, should make loans, for major project capital repairs and improvements, that would carry an interest rate of no more than 6% and be amortized over a time period compatible with the project's cash flow. These direct loans should be made on a revolving basis as part of the present flexible subsidy program.

b. Tax Incentives

(1) Re-establishment of Depreciable Tax Basis

The owner of a project eligible for prepayment should be permitted to re-establish the depreciable tax basis of the project at an amount determined by the project's appraised market value at its highest and best use. In return, the owner would have to agree to maintain the project as low and moderate income housing until the original maturity of the mortgage.

Any owner who agrees to such a lock-in, with or without a re-establishment of depreciable basis, should be permitted to use 65% of any tax losses generated by the project to offset other income, without regard to the new passive loss restrictions imposed by the Tax Reform Act of 1986.

(2) Low-Income Housing Tax Credits for Existing Owners

Owners of existing projects also should be permitted to qualify for low-income housing tax credits, without regard as to when ownership of the property was obtained. The Federal tax code should be further modified to permit these tax credits to be used to offset taxes on any other income of the taxpayer, regardless of source and without any maximum limit.

(3) Non-Taxable Sale to Public and Non-Profit Entity Ownerships

The sale of a limited-dividend, low and moderate income housing project (e.g. 221(d)(3) and 236) to a public entity or non-profit organization should be treated as a non-taxable event, if the sale takes place prior to mortgage prepayment and if the purchaser agrees to continue the low and moderate income character of the project. This would enable the seller to avoid taxation on the gain realized in the sale.

3. ***Expiring Subsidies***

In order to prevent 221(d)(3) and 236 projects from being financially jeopardized or, in the alternative, induced to prepay their mortgages as the result of the expiration of LMSA rent-subsidy contracts, it is recommended that:

a. HUD offer to extend all LMSA contracts to the maturity date of the mortgage in return for a waiver of the owner's mortgage prepayment right.

b. Housing vouchers not be used as a substitute for expiring, project-based subsidies at any time prior to prepayment.

c. Any recaptured LMSA contract authority and/or budget authority be recycled to subsidize units in other projects.

d. The use of five-year, LMSA contracts should be discontinued and any new LMSA contracts should be for a period equal to the remaining mortgage term.

4. ***Tenant Protection***

Owners of projects whose mortgages have been prepaid should be encouraged to retain, to the greatest extent possible, their present low and moderate income tenants, and assistance should be provided to those tenants to assure that they are not required to pay more than 30 percent of income for rent.

Projects whose mortgages are prepaid and are converted to other uses should be replaced so that the inventory of low and moderate income housing is not diminished, especially in tight housing markets.

The Federal Government should determine the need for such replacement housing and be primarily responsible for overseeing its' development by providing grants, project-based subsidies or other appropriate resources.

A "Notice of Fund Availability" (NOFA) should be used to recruit developers for this replacement housing, with priority given to developers who commit to lock-in, without incentive and for the balance of the mortgage term, a project otherwise qualifying for owner incentives and comprising at least the same number of units as those which are applied for under the NOFA. This program would become the "2 for 1 Program."

5. *Increased Income-to-Rent Ratios*

All residents of Section 236 and 221(d)(3) BMIR projects presently paying less than 30% of their income for rent should have that rent payment increased to the lesser of 30% of income or the Section 8 Existing Fair Market Rent for the area. In addition, Section 236 Fair Market Rents, where they are less, should be increased to the Section 8 Existing Fair Market Rents in the area and maintained at that level.

Rent increases necessary to overcome any differential caused by these increases should be limited to 10% per year, in addition to any increase required to cover increased operating expenses.

6. *Less Governmental Oversight*

The resources of experienced HUD personnel at the field level should be reallocated from routine management oversight to the more complex issues related to inventory preservation. Managements with a history of compliance should be reviewed only through annual audits and periodic physical inspections.

7. *Section 8 New Construction and Substantial Rehabilitation Projects*

Owners of Section 8 projects, whose contracts allow them to be cancelled at the end of five-year periods, should be encouraged to forgo these options through use of a revised rent increase formula that will assure every project a reasonable annual rent increase.

HUD should be required to adjust the equity of limited- dividend Section 8 projects, as provided in existing regulations.

8. *A National Housing Advisory Commission*

In 1987, Congress gave recognition to the housing supply problem by supporting the creation of the National Housing Task Force. Support and encouragement was also provided the National Low Income Housing Preservation Commission and this Task Force to examine these issues and to recommend solutions. Collectively, their findings will reflect the best advice that private industry, state and local government, and the general public can provide.

Congress should continue to benefit from this collective wisdom as it proceeds to address the questions of both preservation and future housing supply needs.

The Task Force recommends that the Congress bring together representatives of the three groups, augmented as appropriate, into a National Housing Advisory Commission that would advise the Congress on the effectiveness of different program designs. Importantly, it would tend to infuse the deliberations with the practicalities of housing construction, financing, and management.

It would also provide an unusual opportunity for those interested in solving the housing problems to debate their views and assist Congress in developing a comprehensive new housing policy for this nation.

THE REPORT

I. The Problem

A. The Problem Defined

The problem addressed by this Report is the potential loss by the year 2000 of a very substantial portion of the existing inventory of privately owned, assisted housing units for the low and moderate income.

The Task Force believes it is clear that the United States faces the risk of wide-scale social unrest, substantial losses to the FHA mortgage insurance funds and embarrassment in the world community, unless the Federal Government focuses on the problem in a positive manner so that most of this housing will be preserved for its original purpose.

At the center of this problem are the approximately 2,000,000 housing units (*Exhibit B*) that were built or rehabilitated under the various housing programs described elsewhere in this Report. Their continued use as low and moderate income housing is being threatened in varying degrees by:

- The expiration of project-based, rent-subsidy contracts considered essential to the continued existence of the projects they serve.
- The potential prepayment of project mortgages by owners, resulting in a termination of the obligation to use the properties for low and moderate income housing.
- Aging physical plants that require major capital funds unavailable from conventional sources.
- The potential non-renewal by owners of rent-subsidy contracts for projects which have no other use restrictions, thus permitting the properties to be used for other than low and moderate income housing.
- The absence of future financial incentives to owners to continue to operate within assistance programs, dictating either withdrawal or mortgage default.
- A low level of trust in the Federal Government by the housing industry and the investment community, caused by inconsistency of program administration and a lack of any affirmative Federal policy toward housing, in general, and toward housing for low and moderate income persons, in particular.

The Task Force believes that although the problem is national in scope, it must be solved on a project-by-project basis. Based on individual project circumstances, a variety of solutions will be required.

The dynamics of market value further exacerbate the problem. In markets of high prosperity, the value of a property as a condominium may be several times its value as a rental operation, whereas in economically depressed markets, rental units, at any price, presently lie vacant. These dynamics, in turn, influence the decision-making process of an owner.

It was determined that an evaluation of the problem and the extent to which solutions might be necessary should be conducted from a macro perspective. Therefore, the Task Force has not attempted to create additional statistics that would more minutely define the problem but, instead, has generally relied upon data developed by the Congressional Budget Office, the General Accounting Office, and the Department of Housing and Urban Development.

B. The Causes

The problem, as previously defined, is the result of a Federal housing policy that has become increasingly less responsive to the shelter needs of the low and moderate income.

The Task Force believes this has been demonstrated through:

- The widening gap that has been permitted to occur over the past two decades between the supply and need for affordable housing units.
- A failure by both the Congress and the Administration to appreciate, during the

legislative process, the devastating effect that the Tax Reform Act of 1986 would have on both the financial incentives to maintain the present inventory of low and moderate income housing, as well as on the financial ability to build future housing at affordable rents.

- Failure to provide adequately, in advance, for the housing needs that would arise upon the expiration of the Federal and private commitments supporting the present inventory of privately owned low and moderate income housing.

Although these conclusions come across as critical, it is acknowledged that housing policy and programs developed ten to twenty-five years ago were never designed to face today's problems. The focus of both the Congress and the Administration during that period was supply-oriented. (The Housing and Urban Development Act of 1968 contemplated the provision of six million low and moderate income housing units over the ten-year period ending in 1978. The initial budget requests by the Administration in 1974–76 for Section 8 funds contemplated 300,000–400,000 units per year, 75% of them for construction or rehabilitation.) It was also anticipated that the population segment being served would be upwardly mobile, thereby diminishing the need for further housing assistance.

Unfortunately, that upward mobility, in relation to housing costs, did not occur to the degree anticipated. At the same time, the number of those in need of housing assistance grew without a corresponding increase in the supply of affordable housing, as the projections and promises of 1968 and 1974–76 were never fulfilled.

As a result, a massive housing preservation and supply problem has come to pass.

C. *The Extent*

1. *The National Scene*

To fully understand the severity of the problem that a loss of any significant portion of the existing inventory of low and moderate income housing would cause, it is necessary to review the totality of circumstances confronting the low and moderate income.

- In the 1983 Annual Housing Survey (the latest one available), the Census Bureau found 8.4 million renter households earned less than $7,000; over one-half of these households paid more than 60% of their income for rent.
- Also in 1983, 86% of the 2.2 million renters with incomes below $3,000 per year paid more than 60% of their income for rent.
- Between 1970 and 1980 the number of housing units affordable to a household earning $5,000 or less a year dropped from 15 million to 3 million, while in 1980 there were still 6 million households earning $5,000 or less a year.
- At the end of 1987, an estimated 700,000 people in the United States were homeless.* It has been estimated that this number will grow significantly unless the supply of low-income housing is increased. Even worse, this does not include the "hidden homeless," those who live in overcrowded conditions.
- The number of low-income households rose by 5.8 million between 1975 and 1983, according to Anthony Downs of the Brookings Institution, far in excess of new housing supply for that segment of the population.
- Hundreds of thousands are on the waiting lists of existing low and moderate income housing projects.
- Since 1981, Federal housing assistance funds for additional low and moderate income housing units have been reduced nearly 70%.
- The effects of the 1986 Tax Reform Act have contributed to a substantial decline in construction of any new rental housing.

It seems clear, therefore, that tenants who may be displaced from the existing inventory of low and moderate income housing could well fall out of the housing market altogether.

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*Characteristics and Housing Needs of the Homeless, Prepared for The Committee for Food and Shelter, Inc. by ICF Incorporated, December 31, 1987.

2. The Existing Inventory

There are approximately 2,000,000 units of federally assisted, privately owned housing for the low and moderate income. (A precise count does not seem to exist. While HUD is the prime source, data issued by it does not always agree with data issued by GAO and others, even though purportedly derived from HUD data.) Over 900,000 other privately owned units are occupied by tenants with assistance under HUD's Section 8 certificate or voucher programs. *Exhibit B* provides an estimated breakdown, between programs, of this inventory.

The threat to this inventory arises in three principal areas:

a. The Prepayment of Mortgages

According to HUD, there were in June, 1987, *360,528 units* in *3,215 projects* with mortgages which were either insured or held by HUD under its 221(d)(3) and 236 programs and which are eligible for prepayment after their twentieth year. Through 1995, 316,481 of these housing units in 2,875 projects will have achieved that eligibility for prepayment (*Exhibit C*).

Not included in the above totals are 240,906 units in 221(d)(3) and 236 projects owned at the time of final endorsement by a nonprofit organization or a cooperative or which are receiving, for some or all of their units, payments under HUD's rent supplement program. The mortgages on these projects can only be prepaid before their 40-year maturity with HUD approval.

In addition, several hundred of the projects eligible for mortgage prepayment after twenty years have been assisted with flexible subsidy. While the mortgage on a project which has received flexible subsidy assistance may be prepaid after twenty years if there is no other inhibition, the project is still required to be maintained for low and moderate income use until the end of the original mortgage term. It is expected that this latter requirement will forestall the great majority of permitted prepayments for projects which received flexible subsidy.

Even when a project has the unfettered right to prepay its mortgage, the decision as to whether to exercise that right will depend on the unique circumstances affecting that project in such areas as: market conditions, level of dependence on direct rent subsidy, physical condition, attitude of the owner toward change, etc.

A single project, otherwise eligible for prepayment, is immediately faced with a series of practical business questions, indeed a combination of such questions, for which no single answer may suffice:

- Will the market support necessary higher rents?
- Will the physical condition and/or design permit upgrading at an acceptable cost?
- Will present dependency on rent subsidy permit market oriented rent levels without significant tenant displacement?
- Will replacement housing be available if tenant displacement occurs?
- Will a reasonable incentive(s) to maintain the project for low and moderate income occupancy be preferable in lieu of converting the property to other purposes?

From a practical standpoint, the owner may elect to prepay for the purpose of converting to a market-rate rental or condominium operation, if it is reasonably apparent that the property will command rents or sales prices that will yield an acceptable profit after renovation costs, rent-down and rent-up expenses and increased debt service payments. Because such a conversion involves a fundamental change in a project's image and market, the task, in the majority of cases, will not be an easy one.

A most significant factor in determining the probability of prepayment is the rather extensive existence of direct rent subsidy in the eligible projects.

HUD statistics show that a substantial percentage of the 3,215 prepayment-eligible projects have varying levels of Section 8 project-based assistance (LMSA); in fact, 42% of all units in those projects eligible for prepayment through 1995 have such assistance. This level of dependence on artificial rent support suggests that many of these projects are not in market locations that will permit any conversion of use, regardless of the owners' desires.

The physical condition of many of the prepayment-eligible projects will be such as to cause improvement costs to be prohibitive, if a conversion to market-rental use is undertaken. Although dealt with elsewhere in this Report, a recent HUD study indicated that 23% of all projects insured before 1975 were in poor physical condition, suggesting the additional obstacles of poor market image and the need to incur high renovation costs if a conversion to nonsubsidized operation is to be successful.

HUD took these many factors into account in its March, 1987 project-by-project analysis of prepayment probability. The results of that analysis, as contained in Assistant Secretary Thomas T. Demery's March 26, 1987 testimony before the House Subcommittee on Housing and Community Development, indicated that 84,257 units in 739 projects would "definitely prepay" and that an additional 70,022 units in 622 projects would be "likely to prepay." These *154,279 units in 1,361 projects* represent 25.5% of HUD's present inventory of 221(d)(3) and 236 units.

The HUD estimate, however, does not reflect the individual owners attitudes, nor does it reflect the extent to which any reasonable financial incentives (including long-term, rent-subsidy contract extensions) would affect the apparent bias to prepay.

The Task Force believes that the HUD estimates are high and that the concern over inventory loss due to prepayment has been somewhat overplayed. The Task Force believes that positive Federal intervention, in the form of subsidy contract extensions, low-interest improvement loans and other financial incentives, should reduce the loss of the HUD-insured inventory from prepayment to below 100,000 units, perhaps to no more than 50,000 units.

A separate analysis was not made of either state-financed 236 projects or of the low and moderate income housing projects financed by the Farmers Home Administration under its Section 515 program. According to HUD, there are *117,627 units* contained in projects receiving assistance under the 236 program but financed under a state or local program. Approximately 13,000 of these units receive rent supplement assistance and another 15,000 receive 236 RAP deep subsidy payments.

According to GAO, there were approximately *319,000 Section 515 units* in 1985. About 44,000 of these units receive HUD Section 8 assistance. Other units receive deep subsidy through FmHA's rural rental assistance program. While 515 loans made since December, 1979 have a 15 or 20 year bar on prepayment, loans made before that date can be prepaid at any time without prior approval. These represent about one-half the present inventory.

FmHA projects serve small communities, where the opportunity for conversion and added cash flow is relatively limited. In that sense, the potential for loss from the inventory would seem to be quite low.

Perhaps the most effective incentive that could be offered owners of these projects would be some relaxation of bureaucratic control of rents and project operations. Many owners feel that the degree of control exercised by FmHA offices, frequently unfamiliar with rental project operations, is stifling and counterproductive to long-term continuation with FmHA. Many projects also have to contend with depressed rents and almost non-existent cash flow. A more relaxed operating environment would be an important deterrent to prepayment.

For the most part, units financed by state agencies have been well monitored, the quality of the housing is high, and reserves are reasonably ample. The relationship between owners, the state agencies and the individual communities is relatively strong. The determination of whether a prepayment will occur or whether the project will otherwise cease to serve low and moderate income tenants is governed in most instances by state statutes and regulations. As a result, there is a high potential for understandings being reached for retaining much of this housing for low and moderate income occupancy. The recent initiative of the state of Massachusetts in this regard is an outstanding example of this working relationship.

The Task Force believes that the losses from the inventory of state-assisted 236 housing will be relatively small, due to expected initiatives on the part of state agencies and the municipalities in which the projects are located. Such a positive result will be even more likely if HUD is given the authority and funds to support these state agency initiatives.

b. *Expiring Subsidies*

Expiring subsidies are a matter entirely different from prepayment and, by far, represent the major threat to the existing inventory of low and moderate income housing. The loss of these subsidies, whether project-based or tenant-based, will affect a much larger number of units than those contained in projects eligible for prepayment.

There are some *280,000* project-based, rent-subsidized units (commonly referred to as loan management setasides or LMSA) in privately owned, assisted housing, representing almost 50% of the existing inventory of units in Section 236 and 221(d)(3) projects with mortgages insured or held by HUD. These units are more heavily concentrated in the projects eligible for prepayment prior to the maturity of their mortgages.

Almost one-half of these units were allocated in the late 1970s to help out projects which were in difficulty, primarily those under the 221(d)(3) BMIR and 236 programs. Another large percentage of these units was allocated during the first half of the 1980s to replace rent supplement units in projects with mortgages insured or held by HUD. Another smaller percentage has been used by HUD in connection with its disposition of properties acquired by it through foreclosure. This last use is continuing, as is the use of a limited amount annually to assist troubled projects.

These LMSA units were usually allocated for a 15-year period (the maximum permitted by statute for Section 8 existing housing assistance). The contracts were for an initial period of five years, renewable for two additional five-year terms at the option of the owner (sometimes with HUD assent). However, many allocations and contracts in the last few years have been for only five years, except for rent supplement conversions.

There are over *700,000 units* receiving Section 8 assistance in projects that were newly constructed or substantially rehabilitated in order to receive the Section 8 assistance. About 40% of these units are in projects with mortgages insured or held by HUD. The majority of the other 60% are in projects financed by state and local agencies, usually with tax-exempt bonds. Approximately 44,000 units are in FmHA 515 projects and a relatively small number of units are in projects conventionally financed. (Not included in this total are about *190,000 units* in Section 202 direct-loan projects for the elderly.)

While the largest percentage of Section 8 projects receive the subsidy for all units in the project, there are a substantial number of projects with a lesser percentage of units assisted. Many of these latter projects have only 20% of their units subsidized under Section 8. In 1979, HUD mandated that all Section 8 projects enter into a minimum 20-year contract. Prior to that time, contracts were for five years, renewable at the option of the owner. In a limited number of situations, HUD permitted maximum contract terms to extend for as long as 40 years, predominantly for projects financed by a local or state agency.

There are over *100,000 units* in Section 8 moderate rehabilitation projects. This assistance is project-based, and in some instances, does not cover all the units in the project. The program commenced in 1980, with the Section 8 assistance provided for a single 15-year term.

In addition to the above-listed types of Section 8 project-based assistance, HUD has contracts outstanding under the Section 8 existing program for over *960,000 units*. These contracts are predominantly for certificates, although in the past few years vouchers have come into substantial use. In either case, the assistance is provided to a particular tenant and not for a unit in a specific project.

Assistance under the Section 8 existing program is provided through public housing authorities (PHA). In the case of certificates, the PHA contracts with the owner to provide assistance for the tenant; in the case of vouchers, the tenant receives the assistance directly. Certificates are funded through contracts between HUD and the PHA for an initial five-year term, renewable for two more five-year terms. Voucher assistance, however, is only for one five-year term.

With project-based Section 8 assistance covering about *1,300,000 units* and Section 8 tenant-based assistance covering another *960,000 units*, the total of over *2,200,000 units* constitutes the overwhelming portion of the nation's inventory of privately owned low and moderate income housing. These units are in danger of being lost from the low and moderate income housing inventory at a much faster pace, and in much larger numbers, than the units at risk as a result of the prepayment of 221(d)(3) and 236 mortgages.

This threat to the inventory arises for the following reasons:

(1) The largest dropout will occur in the Section 8 tenant-based subsidy area. Starting in 1990 when the contracts for 12,000 units will expire, contracts for a total of at least *636,000 units* will expire by the end of 1995, assuming maximum contract terms. By the year 2000, almost all of the present inventory of Section 8 certificates and vouchers will have expired, leaving over *800,000* low and moderate income tenants without needed housing assistance. These expirations could occur even earlier, if PHAs chose not to maintain their contracts with HUD for their maximum 15-year terms. At the present time, this is deemed unlikely.

(2) Starting in 1991, subsidy contracts will begin to expire for LMSA units that, in large part, were furnished during the last half of the 1970s to distressed Section 236 and 221(d)(3) BMIR projects with HUD-insured mortgages. However, with many thousands of the units made available since FY 1984 carrying only one five-year term, some of the LMSA expirations will begin to occur in 1989 and increase each year thereafter. Practically all of the *280,000 LMSA units* will have lost their Section 8 support by 2000, with the rate at which that assistance actually terminates depending upon the extent to which project owners exercise the option for their third, five-year term.

(3) In 1996, the 20-year terms on Section 8 new construction and substantial rehabilitation con-

tracts will begin expiring. The expiration rate will increase rapidly through the year 2000, by which time over *200,000 units* will be off subsidy. About 180,000 of these units could be lost to the low and moderate income housing inventory by 1994, if their owners elect to terminate their Section 8 assistance at the end of their Section 8 contract's second or third five-year term.

(4) Between 1995 and 2000, the contracts on over *90,000* Section 8 moderate rehabilitation units will expire.

In summary, over *700,000 Section 8 units* will be lost from the low and moderate income housing inventory by 1995. If owners choose to opt out of their contracts early, this loss could approach *one million units* by 1995. By 2000, the loss will be close to *1.4 million units*. These losses will be occurring at the same time that the prepayment limitations are expiring on some *300,000* 221(d)(3) and 236 units. In fact, many of these Section 8 subsidies are being used to enable tenants to pay their rent on these 221(d)(3) and 236 units. The expiration of the rent-subsidy assistance for a project could well be the precipitating factor in a decision to prepay.

c. Physical Condition

For several years, the assisted housing industry has warned the Federal Government that the aging of physical plants was a growing threat to the viability of the existing inventory of low and moderate income housing.

This concern has arisen because of an absence of adequate project cash flow levels for major component replacement and an inadequacy of project replacement reserves.

1982 industry and HUD surveys of the problem supported these conclusions and indicated a wide-spread need for significant continuing repairs and improvements to the existing stock.

This need was alleviated, to some degree, during 1981–1984 when the re-syndication of project ownerships generated an average of $1000 per unit for upgrading of physical plants for over 100,000 units of the older HUD inventory.

Despite this fairly recent infusion of funds, the problem continues, threatening project viability and influencing the owners' attitude towards continuing in business under any terms. Unless a viable source of funds is made available, an important percentage of the existing stock will fail despite best intentions.

Exhibit D shows that 33% of the older HUD inventory, or about 300,000 units (at least 80,000 in assisted projects) are in trouble either because of high repair needs or very little cash flow from operations to meet ordinary repair needs. Although many of these units are in projects with a high level of Section 8 rental assistance, the projects are still functioning at the margin. This situation highlights the critical need for long-term continuation of these project-based subsidy contracts.

D. Summary

The present inventory of privately owned, low and moderate income housing faces substantial reductions over the next several years. By 1995, the reduction could approach *1.2 million units*. By the year 2000 that reduction could exceed *1.8 million units*.

As the foregoing analysis shows, however, the greater risk of loss is not from the area about which most of the concern has been expressed. While there is no question that the prepayment of mortgages on HUD-insured 221(d)(3) and 236 projects could result in the loss of about 316,000 units by 1995, over 700,000 units could be lost by 1995 as the result of expiring Section 8 subsidy contracts. The loss from such expiring contracts could be almost 1.4 million units by 2000.

HUD has estimated that a maximum of 154,000 units can be expected to be lost from the low and moderate income housing inventory as the result of the prepayment of 221(d)(3) and 236 mortgages. It is likely that this number can be reduced to below 100,000 units, with the provision of appropriate project aid and financial incentives.

In fact, if additional assistance is not provided in the form of extensions of subsidy contracts and low-interest improvement loans, many more units may be lost, not from prepayment but from foreclosure and physical deterioration. Even with the financial stability that comes with Section 8 LMSA rental subsidies, many projects are finding it increasingly difficult to raise the funds needed for capital repairs and replacements. For those projects, the nonrenewal of their subsidy contracts will be disastrous. Beyond that, however, all of these projects will need a source of affordable funds to overcome the effects on their physical plants of age and forced neglect.

II. The Conflict

Solutions should not be proposed without full consideration and understanding of the conflicting perspectives and positions of the three parties to the problem: the tenants, the owners and the Federal Government.

During the Task Force's eight-month study, these conflicts continually confronted the Task Force. What seemed at times to be a deep ravine between the positions of the owner and the tenant was bridged by returning to the fundamental reasons why and for whom the housing was created. The existing inventory of privately owned low and moderate income housing was the result of a public/private partnership that combined public resources and private expertise to build this needed housing. It represents an almost irreplaceable investment of public and private resources. The Task Force concluded, therefore, that this housing can continue to serve its original purpose only with continued Federal support and with a continuation of the public/private partnership. Straying from this basic premise only leads to an intractable problem that has no solution.

The Task Force believes that this present inventory has worked as intended and has served the country well. All parties involved—the tenants, the owners and the Federal Government have realized intended benefits:

- The government has met a public obligation of providing needed housing for those who could not otherwise provide for themselves.
- Many millions of persons have enjoyed decent, affordable housing that would not have been available in the absence of the public/private effort to provide that housing.
- Owners have had an opportunity to realize their goal of a return on their invested capital or the fulfillment of a community obligation, as the case may be.

Each of the three parties continues to have its own perspective of the problem, however. Summarizing these perspectives helps to provide a better understanding of the complexity of the problem.

A. Perspective of the Tenants

There are several million persons presently occupying this housing. Many have occupied the same dwelling unit for years. These people understand, from their personal experience, that there is a shortage of affordable housing. They clearly understand that if their present housing is no longer affordable, they may have no place to go.

As a result, those who express the tenants' viewpoint believe that no dwelling unit should be lost from the current inventory for any reason, unless an affordable unit of equal quality and at no higher cost is provided the tenant being affected.

B. Perspective of the Owner

The owner believes that there is a clear right to prepay the mortgage upon the expiration of any contractual limitation on prepayment and, then, to use the property for other purposes.

The owner believes in protecting the tenant but feels it should not have the financial burden of providing such protection if all its other obligations have been met. Furthermore, protection of the tenant should not override the owner's right to decide how to use the property.

The owner also believes that there is a Federal obligation to provide continuing rent-subsidy support to any project, if the project's viability as low and moderate income housing is dependent on that support. If there are Federal restrictions on occupancy, rent levels and mode of operation, there is also a Federal obligation to assure that the project can function within those constraints.

C. *Perspective of the Federal Government*

In recent years, there has frequently been sharp variance between the Congress and the Administration as to what role, if any, the Federal Government should have in preserving the present inventory of low and moderate income housing. There even has been sharp, if not as public, variance within the Administration, between the Office of Management and Budget and the Department of Housing and Urban Development.

From the evidence at hand, OMB seems to have prevailed within the Administration where there has been relatively little concern shown during the past several years for preserving the supply of affordable housing for the low and moderate income. This demonstrated lack of concern has placed the Administration in direct conflict with the position of both the tenants and the owners. This is illustrated by the following points:

- Whereas the owners and tenants believe that the widening gap between housing supply and demand for low and moderate income housing is exacerbating the inventory preservation problem, the Administration holds to the position that there is an adequate supply of housing and that the question is only one of affordability.
- The Administration has consistently sought to reduce funds for subsidized housing programs, resulting in a 70% decline in the amount of funds available for additional low and moderate income housing since 1980.
- Whereas the owner believes that a continuation of long-term, project-based rent subsidies is essential to the viability of projects that have depended on that subsidy to date, the Administration's position is that relatively short-term housing vouchers provide an acceptable substitute.
- Whereas the tenant asks "Where do I go if I am displaced by prepayment in a tight housing market?" the Administration's position is that housing vouchers will satisfy the problem.

The Congress, on the other hand, has expressed increasing concern over the past three years, holding hearings and discussing extensively how best to preserve the present inventory. In its actions, it has also recognized the need to continue to maintain a substantial supply of low and moderate income housing, instead of relying solely on providing assistance through such means as vouchers. The recent actions by the Congress in the Housing and Community Development Act of 1987 are indicative of this concern and of the recognition that the Federal Government must take positive action for preservation.

D. *The Ownership Environment*

The ownership environment is a further complicating factor.

In the majority of cases, the ownership of limited-dividend, low and moderate income housing is in the form of limited partnerships, made up of at least one general partner and up to 35 limited partners. Although the general partner is regarded as the owner, in fact only 1% to 5% of the ownership normally is held by that entity, with the remainder held by limited partners. Both types of partners may share equally in any residual value in the property.

The limited partners made their investment as a financial transaction involving required payments and the expectation of commensurate tax losses. They have had no emotional involvement in the housing and, in most cases, may never have seen the property in which the investment was made. Most likely, the investment was not socially motivated. While the general partner has the responsibility of determining when a project's mortgage will be refinanced or the project sold, he has a fiduciary obligation to exercise that responsibility in the best interests of the limited partners.

The right to prepay will usually arise at the same time that a project's original investment benefits will have been fully dissipated. As a result, there is little incentive, whether the owner is a limited partnership, an individual or a corporation, to maintain the status quo. For example:

- Tax loss benefits will have been extinguished, due partly to the Tax Reform Act of 1986 and partly to the passage of time.
- Phantom income (taxable income without cash flow to pay the tax) will occur increasingly, as tax losses disappear and as project cash flow is used for such taxable purposes as principal payments, replacement reserves and residual receipt funds. This situation will be exacerbated for 236 projects, as the interest reduction payment is credited increasingly toward non-deductible principal rather than tax-deductible interest.
- Permitted return on equity is totally out of tune with today's economic realities — time has long since passed by both the maximum 6% return rate and the 20-year old equity base against which that rate is applied.
- The need for major capital repairs is growing without any affordable source of funds to meet the need.
- There is no resale market for the projects with their present HUD-imposed limitations, due to the effects of the Tax Reform Act of 1986.

This is the environment in which the owner, usually through a general partner, must decide when the prepayment option matures and/or rent-subsidy contracts expire.

E. Summary

The confluence of these conflicting perspectives surfaces a number of questions, the answers to which are critical to determining workable solutions:

1. If a tenant is displaced for any reason, where will a replacement unit be found in areas of high market value and who will bear the responsibility of finding that unit?

2. How will rental increases be paid by those presently paying 30% or more of their income, if a subsidy contract expires or if rents rise to market levels in a project where a mortgage is prepaid?

3. What obligation does the Federal Government have to continue to provide the support necessary to maintain project viability and affordable shelter for the tenants?

III. Conclusions and Recommendations

A. Conclusions

1. It is important to recognize that the low and moderate income housing in question is the result of an earlier public/private partnership, which combined public resources and private development expertise in producing housing which served an important public purpose. There is a need to reaffirm that public purpose and recognize that just as the Federal Government has a responsibility to honor its contracts with the owners, it also has an obligation to protect the low and moderate income residents of this housing — and that this obligation continues to be in the public interest.

The public/private partnership which produced this housing must be revitalized to focus on this dual responsibility to the owners and to the low and moderate income residents. The Federal Government should, logically, serve as the convener of the partnership — the reviewer of plans and the first source of incentives to preserve the greatest possible number of units in the present inventory of low and moderate income housing. The States and their local governments and the private owners must assume active roles in working with the Federal Government and residents to structure plans which address, cost-effectively, the individual needs of developments. Each of the participants has a stake in the positive resolution of this issue.

2. Every reasonable effort must be made to preserve the existing stock

of privately owned, assisted housing as continued shelter for the low and moderate income.

a. Incentives should be provided to project owners in a manner and at a level that will induce the owner to retain the low and moderate income character of the project for the long term and in the most cost effective manner available.

b. Long-term renewal of expiring, project-based rental subsidy contracts should be provided for the viability of the projects and the protection of the tenants.

c. Low-interest loans should be made by HUD, as part of its management oversight responsibility, for major project repairs and improvements.

3. Low and moderate income residents of existing, assisted housing should be provided continuing, affordable shelter of at least comparable quality and cost, if their housing is lost from the inventory due to governmental action.

4. All tenants should pay a fair share of their income for rent.

5. The contractual rights of the owner should be honored, both retroactively and prospectively.

6. Preventive action taken should be of a long-term nature.

7. Owners should take into consideration the needs of their tenants and should be responsive to offers of governmental incentives to deter prepayment.

B. *Specific Recommendations*

1. *The Prepayment Issue*

The Section 221(d)(3) and Section 236 housing programs were created to provide affordable shelter for the low and moderate income.

Low-interest loans, interest-reduction subsidies, and direct rental assistance were provided by the Federal Government, in order that rent levels could remain affordable. Private industry was asked to contribute capital and expertise through developing, owning and managing this housing. Mechanisms were devised that made this participation both possible and worthwhile.

The mortgages on limited-dividend projects provided that the mortgage could be prepaid without the consent of HUD, starting twenty years after the final endorsement of the mortgage by the government. The property would then be freed of any use restrictions imposed by the regulatory agreement, absent other contractual arrangements to the contrary.

These 20-year prepayment limitations have begun to expire in the last few years and their number will increase substantially starting in 1989 and peaking in 1994. Unfortunately, these limitations are expiring at the same time that years of neglect of the nation's low and moderate income housing needs have resulted in a growing shortage of affordable shelter. The peak expiration period will also coincide with the beginning of large-scale expiration of rental subsidy contracts under the various Section 8 existing housing programs.

a. *Basic Precepts*

In providing solutions to this problem the Task Force believes that:

(1) The owner has a clear contractual right to prepay and to use the property for other purposes, unless prohibited by other contracts.

(2) Low and moderate income tenants of the existing inventory of privately owned assisted housing should be provided continuing, affordable shelter of at least comparable quality and cost, in the event the tenant's unit is lost to the inventory due to prepayment.

(3) In the event of prepayment, the tenant should be permitted to remain in place at no

increase in rental cost to the tenant, except for regulatory reasons, until replacement housing of comparable cost and quality is available.

(4) It is the obligation of the Federal Government to provide this affordable replacement housing, as well as Section 8 rental assistance, as long as a tenant remains in the project pursuant to the preceding paragraph. The Government should also accommodate any relocation costs that might occur.

It is imperative that the seriousness of this issue be fully recognized by the Administration and the Congress. Programs should be put in place as soon as possible, to encourage owners to maintain their projects as low and moderate income housing and to assist the tenants in those projects whose mortgages are prepaid. If vouchers are chosen as the preferred tenant aid, those vouchers must be structured so as to protect the tenant against high market rents in tight housing markets. Further, these vouchers or other aid must be provided on a timely basis, so that prepayment action is not hindered or otherwise delayed.

A mechanism should be established that will identify an owner's intent for the future use of a project early enough to provide effective aid to affected tenants. If that future use is market-rate rental, sufficient rental assistance to keep existing tenants' payments affordable should be provided until alternative, affordable housing is located. If other than market-rate rental use is intended by the owner, a reasonable time period should be provided for the Federal Government to identify alternative, affordable housing for all low and moderate income tenants.

b. Estimates of Inventory Loss

The Task Force believes that solutions can be found to reduce significantly previous estimates of the number of units that may be lost to the inventory through prepayment.

Indeed, it is possible that losses due to prepayment may not exceed 50,000 units if the problem is dealt with realistically and in a timely fashion. The reasons are:

- Many owners would choose to remain in place if appropriate benefits and a suitable operating environment are provided.
- The cost of conversion to market-rate rental operation could be prohibitive in terms of physical improvements, rent-down and rent-up expenses, and the potential problem of tenant unrest.

Many markets could not sustain the sizeable rent increase that would be necessary to accommodate expanded debt service and capital improvements.

c. Market Value—A Fundamental Determinant

The market value of the project should be a fundamental determinant in the negotiation process to decide the level of action, if any, that should be taken by HUD in endeavoring to persuade the owner to waive prepayment rights and/or to retain the low and moderate income character of the project. It is also market value that will influence the owner in evaluating the decision to prepay or to remain in place.

The Task Force, therefore, recommends that the following procedure be adopted by HUD for universal use as a basic beginning point for negotiations with owners.

(1) As soon as possible but in any event no later than the seventeenth anniversary of final endorsement, every project should be appraised to determine its market value at its highest and best use—absent of any regulatory constraints and/or any rent subsidy.

(2) In order to evaluate properly the cost of retaining the project in the low and moderate income housing inventory, the market value, as determined above, should be compared to the replacement cost of building similar projects, at the same time as the appraisal, on available land in the same market area.

The difference between the market value and the loan balance should be calculated so as to determine the amount of "locked-in" or imputed equity. This amount should then be used to determine the extent and nature of incentives to be offered to the owner to maintain the project in the low and moderate income housing inventory.

If the market value is above 85% of the replacement cost of the project, it probably would be cost effective to allow the owner to prepay the mortgage and to replace the project with a new project.

d. Housing Vouchers as Displacement Assistance

It should be recognized that the use of housing vouchers to assist in providing affordable replacement housing in the event of prepayment is apt to encounter difficulty in areas where housing is at a premium.

It is believed imperative, therefore, that in these areas of tight housing supply, the vouchers should be supplemented with a relocation benefit that, together with the voucher allowance, will cause full fair market rent to be affordable to the tenant displaced by prepayment.

Failure to do this will result in an unworkable voucher program in areas where the need is greatest.

2. Incentives to Owners

Limited-dividend owners of assisted housing had varying reasons for their original investment in the housing. For the most part, they were motivated by the level of return that could be realized from the investment, expressed in terms of syndication profit, cash flow, tax losses and/or residual value.

In many cases, circumstances have changed since that original investment was made and original investment expectations may no longer be achievable. Nevertheless, the owner continues to be motivated by what makes financial good sense, either in terms of converting the property to a more profitable use, maintaining present uses, or permitting default to avoid future losses.

The preservation of the inventory is largely dependent, therefore, on providing the owner with a proper reason or incentive to maintain a project's present low and moderate income housing use. While state and local governments, and in some cases nonprofit organizations, may be in the position to provide the necessary incentives, the Task Force believes that the predominant incentive source will have to be the Federal Government, as it has been in the past.

No one incentive or reason may respond to the needs of the universe of properties involved. The posture of each project is unique in terms of market, location, design, physical condition, tenant profile, the level of dependence on rent subsidy, and the requirements of the owners.

These factors may dictate the need for a combination of incentives, in order to provide an appropriate long-term solution.

Using the results of the market value appraisal as a negotiating tool, incentives should be offered to all owners whose mortgages will be eligible for prepayment. These negotiations should begin as soon as possible but, in any event, no later than three years prior to the date of the project's twentieth anniversary, in order that the problem can be addressed in an orderly, cost-effective manner. This would require some 900 projects containing over 100,000 units to be addressed during 1988, in order that potential prepayments through 1991 may be dealt with in a timely fashion (see *Exhibit C*).

Any rent increase necessitated by the use of one or more of the suggested incentives should be phased-in, so as to assure that no unit's rent increases by more than 10% over the previous year's rent, in addition to any increase required to cover increased operating expenses. Where the incentive increase would cause the tenant's portion of the rent to exceed 30% of income, extra rental subsidy should be provided by the Federal Government.

Because any rent increase must be approved by HUD, the decision, as to whether to permit the full amount of the rent increase necessary to fund implementation of one or more of the suggested incentives, can be part of the negotiation process between HUD and the owner. Many projects will not necessarily need as high a rent increase as would be possible by making full use of the proposed incentives and those owners could likely be induced to maintain their projects for low and moderate income occupancy for a lesser amount. HUD will also have to weigh the reasonableness of the increased rent in the project's market area.

a. Financial Incentives

(1) An Increase in Allowable Distributions

The differential between the project's appraised value and the principal balance due on the original mortgage would become the new imputed equity against which the allowed 6% return on investment would be applied.

An example of this incentive in practice is set out in *Exhibit E*. It shows that if the appraised value per unit is $40,000 and the mortgage balance is $12,000, the new equity level will yield a 6% return of $1,680 per unit per year. This compares with an estimated $99 present return. Obviously, this would be an attractive incentive.

Because present rent calculation formulas include the 6% return on investment as a cost item in the determination of approved rents, the above example would result in an increase of about $131.00 per month per unit.

(2) Recovery of Accumulated Equity

The owner should be permitted to secure secondary financing based on the appraised value of the project and subject to a determination by HUD of the ability of the project to generate rents that will amortize the expanded debt service.

(a) The proceeds from such financing would represent a recovery of the equity that had accrued since origination of the project.

(b) The amount that could be borrowed should be limited, however, to the greater of:

- $15,000 per unit, or
- the amount of debt service that could be met by rents that did not exceed 30% of 80% of the project area's median income.

(c) To the extent that the project's cash flow (as a result of phased-in rent increases) is not expected initially to accommodate the increased debt service, an escrow account should be established by the mortgagee from the loan proceeds to ensure that debt service payments are made when due. As soon as cash flow permitted, the escrow would be released to the owner and the owner repaid the portion used for debt service.

(d) The project's replacement reserve should have a minimum balance adequate, with future regular monthly payments, to meet the project's anticipated needs, as a condition of loan proceeds being released.

(e) The Task Force believes that as a matter of public policy, all mortgagees should consider this second mortgage arrangement. However, any program developed should recognize the economic interests of the project mortgagee, whose approval of any such financing is in many instances required by the terms of the mortgage. It is recognized that the mortgagor would have to be credit worthy and the project viable before any loan should be made.

(3) Low-Interest Loans for Capital Improvements

The Federal Government should establish a revolving loan fund from which the owner of a project, requiring repair or replacement of major components or the modernization of units, could be permitted to borrow the necessary amounts.

Such loans would be amortized over a time period and at interest rates compatible with the cash flow of the project, although the interest rate on the loan should be no more than 6%.

The loans should be made by HUD as part of its management oversight responsibility and administered as part of the present flexible subsidy program. This would eliminate costly underwriting procedures and cause funds to be available on comparatively short notice.

b. Tax Incentives

(1) Re-establishment of Depreciable Tax Basis

The owner of a project eligible for prepayment should be permitted to reestablish the depreciable tax basis of the project at an amount determined by the project's appraised market value at its highest and best use. This should enable the owner to shelter from taxation any phantom income arising from the increasing portion of project debt service allocated to principal, as well as shelter some or all of the increased income generated by other incentives.

In return, the owner would have to agree to maintain the project as low and moderate income housing until the original maturity of the mortgage. Any owner who agrees to such a lock-in, with or without a reestablishment of depreciable basis, should be permitted to use 65% of any tax losses generated by the project to offset other income, without regard to the new passive loss restrictions imposed by the Tax Reform Act of 1986.

(2) Low-Income Housing Tax Credits for Existing Owners

Owners of existing projects also

should be permitted to quality for low-income housing tax credits, without regard to the present statutory provision which generally restricts the credits to purchasers of low and moderate income housing projects which have not changed hands for at least 10 years. The Federal tax code should be further modified to permit these tax credits to be used to offset taxes on any other income of the taxpayer, regardless of source and without any maximum limit.

(3) Non-Taxable Sale to Public and Non-Profit Entity Ownerships
The sale of a limited-dividend, low and moderate income housing project (e.g. 221(d)(3) and 236) to a public entity or non-profit organization should be treated as a non-taxable event, if the sale takes place prior to mortgage prepayment and if the purchaser agrees to continue the low and moderate income character of the project. This would enable the seller to avoid taxation on the gain realized in the sale—the difference between net sales price and the property's depreciated basis.

> (a) Non-profit organizations, state and local housing agencies, cities, community groups and tenant cooperatives should be encouraged to buy existing projects as a way of preserving the housing inventory for continued low and moderate income use.
>
> The financing for such transactions could be provided from a variety of sources, with probably the best and most financially feasible source being tax-exempt bonds issued by state and local housing agencies. Whenever possible, this financing should be placed on top of the existing financing, in order to preserve the financial benefits that accrue from the favorable terms of 221(d)(3) and 236 mortgages.
>
> (b) HUD should provide financial assistance to public entities and non-profit organizations purchasing these projects. This assistance could take the form of grants to reduce the acquisition cost, low-interest loans for part of the acquisition cost and necessary repairs, and interest write-downs.
>
> (c) Any offers to buy existing properties should not be treated as imposing a sell-or-else option to owners, who should retain the final right to accept or reject any such offers.

3. Expiring Subsidies
The Task Force believes that the matter of expiring rent subsidies is the major threat to the existing housing inventory and that it far overshadows the threat posed by prepayment.

Approximately 50% of the tenants, in units in 221(d)(3) and 236 projects eligible for prepayment at the end of their first 20 years, are dependent on rental subsidy received under the Section 8 LMSA program. The maximum 15-year contract terms for that assistance will begin to expire in 1991 with an estimated 100,000 units of such assistance disappearing by 1995.

Without the LMSA assistance, many of these projects will be either placed in severe jeopardy for the lack of any other viable tenant population or forced to look to non-subsidized tenants. In the first instance, default will occur; in the second instance, prepayment is likely to occur.

The Section 8 contracts for over 600,000 other units will also expire by

1995, and as many as another 400,000 units could be lost if project owners decide not to renew their Section 8 contracts for additional five-year terms.

Clearly, this problem must be dealt with immediately and affirmatively. Otherwise, mortgage assignments and foreclosures, deteriorating physical plants and a massive displacement of tenants will occur.

The Task Force strongly recommends the following actions as essential to preventing such circumstances from occurring in 221(d)(3) and 236 projects:

a. All Section 8 Loan Management Setaside Contracts Should Be Extended

All Section 8 LMSA rent-subsidy contracts, which expire prior to prepayment of the mortgage, should be extended by HUD to the maturity date of the original mortgage. In return for this extension, the owner should be required to waive its mortgage prepayment right. It is probable, however, that the issue of incentives will also have to be addressed at the same time, to induce the owner to give up its prepayment right.

Short-term contract extensions serve only to delay the inevitable. The Task Force strongly believes that any solutions adopted should be of a more lasting nature.

b. Inadequacy of Housing Vouchers as a Project-Based Subsidy Substitute

The Task Force considers housing vouchers to be an inadequate substitute for expiring, project-based rent-subsidy contracts in projects whose mortgages have not been prepaid.

The portability of the voucher would prove damaging to projects that depend heavily on rent-subsidy assistance. Even in the case of well-managed properties, annual tenant turnover may approximate 35%. Thus, a vacant unit to which rent subsidy is not assigned may prove unaffordable for a tenant who has no voucher but who is otherwise eligible. Many such occurrences would quickly destroy the viability of the project.

Furthermore, the single, five-year term of vouchers and their limited provision for necessary rent increases would also soon undermine the viability of any project whose tenant population is generally drawn from the low income.

The Task Force urges, therefore, that vouchers not be used as a replacement for existing project-based rent subsidies in any project whose mortgage has not been prepaid.

c. Recycle All Recaptured Project-Based Subsidy Funds

When LMSA contract authority and/or budget authority is recaptured by HUD due to non-use, that authority should be recycled and put to use for the benefit of other projects.

d. Discontinue Five-Year Project-Based Subsidy Contracts

The current practice of using five-year LMSA contracts to assist distressed projects should be discontinued. Future contracts should be for a term ending on the maturity date of the original mortgage. In return for this assistance, the owner should be required to waive its mortgage prepayment right. The need for any additional incentives to induce this waiver should also be addressed at this time.

4. Tenant Protection

Owners of projects whose mortgages have been prepaid should be encouraged to retain, to the greatest extent possible, their present low and moderate income tenants. To assure that those tenants are able to afford any increases in rent, assistance should be provided on their behalf so as to assure that they are not required to pay more than 30% of income for rent. This assistance would be personal to the tenant and would remain in place as long as the tenant resided in the project.

Projects whose mortgages are prepaid and which are converted to other uses should also be replaced so that the inventory of low and moderate income housing is not diminished. Such action is particularly necessary in tight housing markets where affordable, acceptable units are unlikely to be found by displaced tenants, even if they are provided with vouchers and other relocation benefits.

The Task Force recommends that the Federal Government should determine the need for such replacement housing and be primarily responsible for overseeing and funding its development by providing grants, project-based subsidies and other appropriate resources. In turn, state and local agencies should assist this development as their resources permit.

It is recommended that a "Notice of Fund Availability" (NOFA) process be used to recruit developers for this replacement housing. It is further recommended that priority be given to developers who commit to lock in, without any new incentive and for the balance of the mortgage term, a project otherwise qualifying for owner incentives and comprising at least the same number of units as those which are applied for under the NOFA. This program would become the "2 for 1 Program".

5. Increased Income-to-Rent Ratios
All residents of Section 236 and 221(d)(3) BMIR projects presently paying less than 30% of their income for rent should have that rent payment increased to the lesser of 30% of income or the Section 8 Existing Fair Market Rent for the area. In addition, Section 236 Fair Market Rents, where they are less, should be increased to the Section 8 Existing Fair Market Rents in the area and maintained at that level.

Rent increases necessary to overcome any differential caused by these increases should be limited to 10% per year, in addition to any increase required to cover increased operating expenses.

HUD estimates that approximately 15% of tenants residing in these two types of assisted projects pay less than 30% of income for rent, with some tenants paying as low as 15%. The Task Force believes that this is unfair to those who wait in line for assisted housing.

An additional benefit from this change would be an increase in excess rental payments to HUD from 236 projects. This would increase the funds available for flexible subsidy assistance and, perhaps, help finance the low-interest loans for capital improvements that the Task Force is recommending.

6. Less Governmental Oversight
The Task Force recommends a relaxation of HUD oversight related to the operation of some assisted projects, thus permitting a reallocation of resources to dealing with the increasingly complex issues of preservation that will confront HUD.

- Presently the level of control exerted by HUD over the daily performance of management activities is frustrating to competent management and counter-productive to the goal of encouraging owners to maintain their projects in low and moderate income occupancy.
- Owners and management agents with a history of compliance and satisfactory performance should be removed from the normal oversight system, subject to a review of required annual audits and rent increase proposals and to an annual physical inspection.
- Uninsured projects receiving Section 8 project-based assistance are not subjected to the same detailed management oversight as are 221(d)(3) and 236 projects whose

mortgages are insured or held by HUD. Some owners of 221(d)(3) and 236 projects might be willing to forgo their right to convert their projects to other uses upon exercising their right to prepay after 20 years, in return for relief from this present burdensome management oversight. This would be accomplished by allowing the owner to prepay before 20 years and then providing Section 8 existing assistance to the project for all, or as many of its units as might be appropriate, at the then current Existing FMRs. The Section 8 assistance would be available until the original maturity date of the insured mortgage and the owner would be required to agree to maintain the project as low and moderate income housing for that period.

C. Section 8 New Construction and Substantial Rehabilitation Projects

The manner in which HUD has been administering Section 8 annual rent adjustments in the past few years has greatly disturbed Section 8 project owners. Routine increases based on the annual adjustment factor, in many cases, have ceased occurring or even turned into rent decreases. In some cases, project owners have been actively discouraged from submitting rent increase requests by the threat of a decrease.

These problems have arisen because of the inequitable way in which HUD has been making rent comparability determinations. Welcome new statutory provisions contained in the Housing and Community Development Act of 1987 will remedy many of these problems, including preventing any further rent decreases. However, there is still a great deal of discouragement among project owners and many, whose contracts allow them to withdraw from the program at the end of each five-year term, are actively considering taking that route.

In order to encourage owners to renew their contracts and not opt out of the Section 8 program, the Task Force recommends that a revised rent increase formula be devised that will assure every project a reasonable annual rent increase. Such an incentive is essential in order to avoid the premature loss of thousands of low-income housing units.

The Task Force also recommends, in the case of limited-dividend Section 8 projects which are not able to opt out every five years, that HUD be required to adjust the equity as provided in existing regulations. This is a benefit to which the owners are entitled, but are not receiving.

D. A National Housing Advisory Commission

In 1987, Congress gave recognition to the housing supply problem by supporting the creation of the National Housing Task Force. Support and encouragement was also provided the National Low Income Housing Preservation Commission and this Task Force to examine these issues and to recommend solutions. Collectively, their findings will reflect the best advice that private industry, state and local government, and the general public can provide.

Congress should continue to benefit from this collective wisdom as it proceeds to address the questions of both preservation of the present supply of low and moderate income housing and future housing supply needs.

The Task Force recommends that the Congress bring together representatives of the three groups, augmented as appropriate, into a National Housing Advisory Commission that would advise the Congress on the effectiveness of different program designs. Importantly, it would tend to infuse the deliberations with the practicalities of housing construction, financing and management.

It would also provide an unusual opportunity for those interested in solving the housing problems to debate their views and assist Congress in developing a comprehensive new housing policy for this nation.

EXHIBITS

EXHIBIT A	Membership of the National Housing Preservation Task Force and its Committees
EXHIBIT B	The Existing Inventory of Privately Owned Assisted Housing
EXHIBIT C	Projects Eligible for Prepayment
EXHIBIT D	Estimated Repair Needs of Privately Owned Projects with Mortgages Insured or Held by HUD
EXHIBIT E	An Increase in Allowable Distributions—an example

EXHIBIT A

Membership of the National Housing Preservation Task Force

General Chairman
Mr. G. Lindsay Crump, CPM
Vice President
Marvin F. Poer & Company
Fairfax, VA

Executive Director
Mr. Carl Coan, III
Coan, Couture, Lyons & Moorhead
Washington, DC

Committee Chairmen

Prepayment
Mr. Charles Edson
Senior Partner
Lane & Edson
Washington, DC

Owner Incentives
Mr. Lawrence Simons
Partner
Powell, Goldstein, Frazier & Murphy
Washington, DC

Expiring Subsidies
Mr. Conrad Egan
Executive Vice President
National Corporation for Housing Partnerships
Washington, DC

Tenant Impact
Mr. Barry Zigas
President
National Low Income Housing Coalition
Washington, DC

State and Local Initiatives
Mr. Carl W. Reidy, Jr.
Executive Vice President
National Council of State Housing Agencies
Washington, DC

Rent Levels and Tenant Rights
Ms. Sarah Johnson for
Ms. Marilyn Melkonian
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Mr. Michael Carliner
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Partnerships
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Mr. Lawrence Simons
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Powell, Goldstein, Frazier & Murphy
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Mrs. Johrita Solari
National Federation of AHMA
Anaheim, CA

Mr. Ronald D. Weaver
President
Management Systems, Inc.
Detroit, MI

Mr. Irwin Yeagle, CPM
President
Community Realty Management, Inc.
Pleasantville, NJ

Mr. Barry Zigas
President
National Low Income Housing Coalition
Washington, DC

EXHIBIT B

The Existing Inventory of Privately Owned Assisted Housing

(as of February, 1987)

PROJECT-BASED

Program		Number of Units
Section 221(d)(3) BMIR		604,000
Section 221(d)(3) Market Rate		
Section 236—HUD		
Section 236—State Financed		117,000
Section 8—Insured and HUD Held		298,000
Section 8—Non-insured		437,000
Section 8—Moderate Rehab		100,000
Section 202		200,000[1]
Section 515—Farmers Home Administration		275,000[2]
	TOTAL UNITS	2,031,000

TENANT-BASED

Program		Number of Units
Section 8 Certificates		876,000
Section 8 Vouchers		85,000
	TOTAL UNITS	961,000

1. About 192,000 of these 202 units are assisted with 20-year Section 8 contracts. These are *not* included in the 437,000 non-insured Section 8 units.
2. Another 44,000 Section 515 units are assisted under Section 8 and are included in the total of non-insured Section 8 units.

Source: HUD; GAO

EXHIBIT C

Projects Eligible for Prepayment

(National Totals by Year of Eligibility)
(through 1995)

Year of Eligibility	Total Projects	BMIR Units	Section 236 Units	Total Units
1982-87	71	8,724		8,724
1988	60	8,660		8,660
1989	166	20,285	840	21,125
1990	225	18,334	9,239	27,573
1991	396	13,625	31,509	45,134
1992	489	7,393	41,982	49,375
1993	534	4,282	51,575	55,859
1994	672	4,559	66,167	70,726
1995	262	1,793	27,514	29,307
TOTAL	2,875	87,655	228,826	316,481

Source: HUD Schedules—June, 1987

EXHIBIT D

Estimated Repair Needs of Privately Owned Projects With Mortgages Insured or Held by HUD

(As of 1985)

Physical Condition	Cash Flow Status	Number of Properties	Percent of Total Units
Poor	Poor	264	3.6%
Poor	Good	1,434	19.8%
Good	Poor	696	9.6%
Good	Good	4,872	67.0%
		7,266	100.0%

Source: HUD Office of Policy Development and Research Report dated April, 1987 and entitled, HUD/FHA—Insured Rental Housing Physical and Financial Conditions of Multifamily Properties Insured Before 1975—*Based on data collected in 1985 on a representative sample of properties*

EXHIBIT E

An Increase in Allowable Distributions

(An Example of the probable results of implementing this incentive with the owner of a Section 221(d)(3) BMIR project)

	Amounts at Final Endorsement	Amounts Based on Appraisal
Cost or Appraised Value per Unit	$16,500	$40,000
Mortgage Balance	$14,850	$12,000
Equity	$ 1,650	$28,000
6% Allowable Distribution Based on Equity	$ 99	$ 1,680

SOURCE MATERIALS

A Decent Home
The Report on the President's Committee on Urban Housing
December 1968

HUD/FHA Insured Rental Housing
U. S. Department of Housing and Urban Development
April 1987

The Potential Loss of Assisted Housing Units as Certain Mortgage-Interest Subsidy Programs Mature
The Congressional Budget Office
March 1987

Potential Reduction in Federally Assisted Rental Housing
United States General Accounting Office
Statement of Mr. Neal Curtin before the Subcommittee on Housing and Community Development
House of Representatives
March 1987

At Risk of Loss: The Endangered Future of Low Income Rental Housing Resources
Mr. Phillip L. Clay
Massachusetts Institute of Technology for Neighborhood Reinvestment Corporation
May 1987

The Declining Supply of Low Cost Rental Housing
Testimony provided by Mr. William C. Apgar, Jr., Joint Center for Housing Studies of MIT and Harvard University, for U.S. Senate Subcommittee on Housing and Urban Affairs
June 1987

Testimony
Mr. Thomas T. Demery, Assistant Secretary for Housing—FHA Commissioner, Department of Housing and Urban Development before Subcommittee on Housing and Community Development
House of Representatives
March 1987

Testimony
Mr. Barry Zigas, President
National Low Income Housing Coalition for Senate Subcommittee on Housing and Urban Affairs
June 1987

Pushed Out: America's Homeless
The National Coalition for the Homeless
Thanksgiving 1987

Characteristics and Housing Needs of the Homeless
Final Report—Prepared for the Committee for Food and Shelter
ICF Incorporated
December 1987

ACKNOWLEDGMENTS

The Task Force would like to acknowledge and thank the National Association of Home Builders and the Northern California Association of HUD Management Agents for their contribution and support of the Task Force's efforts. In addition, the Task Force would like to extend a special thanks to Mrs. Kitty Ingram of Vienna, Virginia, who was responsible for the provision of invaluable secretarial assistance. Without Mrs. Ingram's commitment to the finalization of the Report, the Task Force would have been unable to complete its task in a timely fashion.

JCHE

30 Wallingford Road
Brighton, MA 02135
617/254-8008

Rudolph Kass
President
Ellen Feingold
Executive Vice President

March 17, 1988

Mr. Robert J. Leonard, Esq.
Chief Counsel
House Ways and Means Committee
1102 Longworth HOB
Washington, DC 20515

Dear Mr. Leonard,

Jewish Community Housing for the Elderly is a non-profit developer and manager of housing for low-income elderly. At this time, we own and operate 934 units of housing in the Boston area built under the federal Section 202 and 236 programs, and under the Massachusetts Housing Finance Agency. The rents of all but 23 of our tenants are further subsidized under the Section 8 program. Our tenants' median age is over 80 and their median income is under $6,000.

We are constantly working to develop additional housing resources for this population-- growing in numbers, living longer, and needing special help. We are planning our next development as a limited equity cooperative for a variety of reasons, and are trying to figure out how to make the co-op model work for people of modest income. Every financial scenario we develop utilizes reserves and the income from reserves as elements in the long term viability of this housing.

The current interpretation by the Internal Revenue Service of Section 277 of the Code as being applicable to housing cooperatives, and requiring that cooperatives pay separate taxes on certain "nonmember" income without the benefit of any offsetting deductions, jeopardizes our ability to move forward.

Apparently the IRS classifies interest on reserves, even reserves mandated by the U.S. Department of Housing and Urban Development (HUD) or other public lenders, as nonmember income, and therefore subject to taxation. From our point of view, this approach doesn't make sense, since keeping reserves is an essential part of the operation of any housing development, especially a low and moderate income housing development. To provide for separate taxation of any income on these reserves undercuts the value of the Federal and state subsidy which is used to make these projects feasible.

We believe it is urgent that Congress clarify this issue to insure that the original purpose of these Federal programs is served, and we therefore support the proposed amendments to provide relief from this IRS interpretation for certain limited equity cooperatives.

Thank you for your consideration.

Sincerely,

Ellen Feingold

Ellen Feingold
Executive Vice President

MEADOW MANAGEMENT INC.
27780 Novi Rd. • Novi, MI 48050 • (313) 348-5400

March 14, 1988

The Honorable Charles B. Rangel Chairman,
Subcommittee on Select Revenue Measures,
Committee on Ways and Means,
U.S. House of Representatives

RE: HR 3663

Dear Chairman Rangel and Members of the Subcommittee:

As a cooperative housing professional with ten years of experience in the field, I am writing in support of the testimony of Terry Lewis, Esq., President of National Association of Housing Cooperatives. The changes requested in HR 3663 are necessary if well managed low-income housing cooperatives are to be treated equitably.

As managing agent of three limited equity housing cooperatives in Michigan, I am familiar with the need for adequately funded reserves and escrows for the on-going preservation of this form of housing. As these cooperatives have become financially stable and strong, serious concerns have arisen around the treatment of the income derived from their reserves under the current tax code.

The changes suggested by the National Association of Housing Cooperatives go a long way toward alleviating the concerns of well managed housing cooperatives in Michigan and throughout the nation.

Thank you for your on-going attention to these issues. I am appreciative of your efforts to assure that housing cooperatives are treated fairly.

Sincerely,

John E. Lawton
Executive Vice President

Rochester Branch Office:
1400 Drexelgate Parkway
Rochester, MI 48063
(313) 652-3485

Flint Branch Office:
5145 Ridgebend Drive
Flint, MI 48507
(313) 238-9689

Mid-Peninsula Coalition
Housing Fund
430 SHERMAN AVENUE
PALO ALTO, CALIF. 94306
TELEPHONE (415) 327-9280

FEB 26 1988

February 19, 1988

The Honorable Barney Frank
U.S. House of Representatives
1030 Longworth Building
Washington, DC 20515

Attn: Nan Elwood

Dear Representative Frank:

I am writing in regard to HR 3663, the "Low Income Housing Tax Act of 1987." We are very pleased that you are co-sponsoring this legislation, as we believe the provisions will play a very important role in providing affordable housing. However, we would like to ask for your additional assistance in adding provisions to this bill to modify the existing federal low-income housing tax credit legislation in a manner which could have a significant impact in preserving the existing stock of subsidized housing.

As you are well aware, there are hundreds of thousands of units of privately-owned HUD-subsidized housing throughout the country that are at risk of conversion to market rate rentals and condominiums over the next several years as a result of mortgage prepayments and Section 8 contract opt-outs. The problem is particularly acute in California, where rapid growth and escalating real estate values over the past two decades have greatly increased the market potential of these projects.

The Mid-Peninsula Housing Coalition is a private non-profit organization with seventeen years of experience in developing and managing housing affordable to low and moderate-income families in Santa Clara and San Mateo counties. We are currently attempting to purchase existing HUD projects which are at-risk of conversion. Our goal is to maintain these units as affordable housing to the greatest extent possible.

The most valuable resource now available to non-profit organizations for the purpose of constructing or acquiring affordable housing is the federal low-income housing tax credit. In California, a parallel state tax credit can be combined to generate additional subsidy. By creating limited partnerships, tax credits allow us to raise substantial equity, thereby giving us the ability to charge very low rents.

We are currently negotiating purchases with owners of several threatened HUD projects in our area. Most owners have indicated that they do not intend to stay in the HUD programs longer than required, yet are favorable to the idea of selling the projects at fair market value to our organization for the purpose of preserving the low-income character. The main problem we are facing in assembling the financing for these buy-outs is that a project is only eligible for federal tax credits if it has not been "placed in service" within the past ten years. In other words, a project must not have been sold in the past ten years if we intend to raise equity by selling tax credits. We are finding that approximately half of the HUD projects now eligible to convert to market rate have been sold during the past ten years, many following the enactment of the 1981 tax act.

There are several owners of HUD projects in our area who are currently interested in selling the housing to our organization to maintain long-term affordability. However, because these owners have owned the projects for less than ten years, we do not have access to tax credit financing and it is doubtful that we will be able to outbid profit-motivated buyers. The ultimate result will be displacement of low-income tenants.

We would like to encourage you to amend HR 3663 to provide for a waiver of the "ten-year placed in service rule" for buyers of HUD-subsidized projects that are at risk of conversion to market rate housing. Currently, a waiver is available for troubled projects to prevent assignment of the mortgage to HUD. We believe that this waiver should be expanded to include all HUD projects at risk of mortgage prepayment and/or Section 8 opt out. The waiver would not require additional expenditure from the federal government, since tax credit allocations are subject to existing statewide volume caps.

In exchange for this waiver, it would be desirable to require more stringent guidelines for the length of time the housing must remain affordable to low-income tenants. Regulations modeled after the California state tax credit, for example, would require thirty years of low-income use restrictions as long as the low rents are economically feasible. This would essentially eliminate potential abuses of this provision.

A waiver from the "ten-year placed in service rule" for all threatened HUD projects was included in the reconciliation bill which was passed by the House. This waiver, as well as several other miscellaneous provisions included in the reconciliation bill to amend the Tax Reform Act of 1986, could have a significant impact on strengthening the ability of non-profit organizations to utilize the tax credits. We believe these miscellaneous provisions should be attached to HR 3663.

I would be happy to discuss this issue with you or any of your staff in greater detail. Thank you very much for your consideration, and for your continued interest in affordable housing.

Sincerely,

Fran Wagstaff

Fran Wagstaff
Executive Director

MITCHELL-LAMA COUNCIL

MITCHELL—LAMA & ALLIED HOUSING COUNCIL, INC.
(212) 677-4609

175 East 4th Street
New York, N.Y. 10009

March 14, 1988

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, DC 20515

RE: H.R. 3663

Dear Sir:

I submit herewith the written statement of the Mitchell-Lama and Allied Housing Council, Inc., with regard to the hearing of the Select Revenue Measures Subcommittee on H.R. 3663.

The Mitchell-Lama Council represents the organized body of housing cooperatives in the Mitchell-Lama publicly-assisted program in New York. As an affiliated member of the National Association of Housing Cooperatives, we fully support the position stated by NAHC at the recent public hearing on H.R. 3663.

Very truly yours,

Murray Raphael

MURRAY RAPHAEL
President

STATEMENT OF THE MORTGAGE BANKERS ASSOCIATION OF AMERICA

The Mortgage Bankers Association of America submits this statement on low-income housing tax credits and on the role of tax policy in preserving the stock of low-income housing.

The tax credit is of concern to MBA because of its importance as an incentive for the production of low-income housing. It is almost the only remaining tax vehicle for attracting investment capital to providing affordable rental housing opportunities for low-income households.

AFFORDABILITY

The Housing Act of 1949 established as a national goal "a decent home and suitable living environment for every American family." About 60 percent of the housing units in existence today were built between 1950 and 1980, with the quality of our housing stock being significantly improved, as well as the quantity. However, particularly during the 1980s, for a growing number of households, acquiring adequate and uncrowded shelter has become a greater financial burden. In a July 1986 study done by the Department of Housing and Urban Development (HUD), "Attaining the Housing Goal?", a renter is considered to be cost burdened when more than 30 percent of gross household income is devoted to housing costs. Between 1975 and 1983 the number of cost burdened households increased from 12.1 percent to 17.0 percent, or from 8.8 million to 14.4 million households. According to the HUD study, 43 percent of all renters are very low-income households, and in 1983, 45 percent of them were cost burdened, an increase from 37 percent in 1975. The incidence of cost burden for low- and moderate-income households increased from 10 percent to 18 percent. Clearly, housing costs are rising faster than income for an expanding segment of our society.

The need for the preservation of existing low-income housing is as great as the need for new construction. During the last 20 years, about 2 million low-income housing units were constructed with the assistance of various housing programs. Almost half of these units may be removed from the low-income inventory by the year 2000 as either the restrictions on the prepayment of existing Federally assisted mortgages or Federal subsidy credits expire and owners potentially convert the property to other uses.

Congress has already recognized the need to minimize this loss and in the "Housing and Community Development Act of 1987," PL 100-242, enacted a number of measures aimed at doing this, one of which places restraints on the prepayments of mortgages by owners. In addition, HR 3663, the "Low-Income Housing Tax Act of 1987," has been introduced by Representative Charles Rangel (D-NY) to provide tax incentives to prevent the loss of low-income housing. These include restoring depreciable basis to owners who maintain their low-income housing for an additional 20 years, excluding from taxation the gain from the sale of low-income housing due to assumption of indebtedness by a buyer who maintains the housing as low- or moderate-income for another 15 years, and allowing more opportunities for using the low-income housing tax credit.

The units most at risk of being lost as low-income housing are located in larger urban areas with strong markets, because owners can make profitable returns by converting the properties to market-rate rents. Higher returns or greater tax incentives will be necessary to induce owners to continue low-income usage.

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of housing and other real estate finance. MBA's membership comprises mortgage originators and servicers, as well as investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

The low-income housing tax credit was enacted as part of the Tax Reform Act of 1986 (the "Act") because Congress recognized that tax incentives are needed to attract investors to low-income housing. The Act eliminated many existing tax incentives for real estate investment such as accelerated depreciation, preferential treatment of capital gains, and deductions for construction period interest, while imposing the passive activity loss limitations. All of these provisions discouraged future investments in low-income housing. Because Congress realized that the economics of low-income housing do not provide investors with an adequate return on investment, it developed a new tax incentive focused particularly on the production and rehabilitation of such housing.

To its disadvantage, the tax credit is temporary, complex, not fully explained and understood, and in need of some revisions. For these reasons, plus the long lead time needed for real estate development, the tax credit has not been fully utilized. It is crucial that the tax credit be made more attractive in order to counteract the predicted loss of low-income housing units over the next decade.

MBA's involvement with the tax credit has been relatively small. However, MBA supports its continued use and improvements as one means by which we can still produce low-income housing.

OTHER ASSISTANCE AND INCENTIVES

In addition to the low-income housing tax credit, the only other tax incentive for the production of low-income rental housing is the use of tax-exempt bonds. However, the Tax Reform Act of 1986 placed volume caps on the use of these bonds. Clearly, these two vehicles are not sufficient to meet the needs of low-income households. Other forms of direct and indirect (credit enhancement) assistance are needed at all governmental levels—Federal, state, and local. Public housing is needed for the very low-income, as this group needs special support services that are not available in privately produced housing. Production incentives are necessary in tight housing markets to induce private investors to develop housing for low- and moderate-income families and individuals at rents they can afford.

In addition, continued rental assistance is required in areas with an adequate housing supply to help low- and moderate-income households find affordable private sector housing.

USE OF LOW-INCOME HOUSING TAX CREDIT

The low-income housing tax credit became effective on January 1, 1987, and expires on December 31, 1989. In order to use the credit, projects are required to meet a variety of restrictive and complex provisions. The credit was not heavily utilized in the first year of its existence; and when it was used, projects had certain characteristics.

According to a study prepared by the Joint Center for Housing Studies of the Massachusetts Institute of Technology and Harvard University for the National Council of State Housing Agencies, Early Experience with the Low-Income Rental Housing Tax Credit, less than one-fourth of the tax credit authority was used in 1987. It is premature to predict that such low utilization of the tax credit will persist. As familiarity with the credit increases and problems are resolved, it will become more apparent whether the credit can function as an efficient incentive for production and preservation of low-income housing. Therefore, more time is needed to assess the efficiency of the credit.

The Joint Center study found that almost all of the projects were 100 percent low-income. One possible reason for this is that the tax credit subsidizes only low-income units, so there is little incentive to provide mixed-income housing, especially in areas where relatively higher income households prefer to own rather than rent housing. More information is needed, such as the geographic areas where these projects are located, in order to more accurately determine why the projects are predominantly 100 percent low-income.

Evidence also shows that the projects using the tax credit are of a smaller scale, with the average size being a little over 30 units. While there is a pressing need for low-income housing, perhaps business is adapting to the current environment. Projects could be on a smaller scale (with smaller risks) until the efficiency of the credit is known.

PROBLEMS WITH THE CREDIT

The credit has not been widely used for a number of reasons, including the need for some revisions. However, one of the most immediate problems is the lack of regulatory guidance. Even though some proposed regulations have been issued, a host of unanswered questions persist. While a number of mortgage bankers may be interested in participating in projects, they are still in the dark on a variety of issues.

There is also a need for the passage of the provisions in the "Technical Corrections Bill" to the 1986 Tax Reform Act. Enactment of these amendments would improve the effectiveness of the credit. These provisions include the carryover of a state's tax credit authority to the following year. Projects should not be penalized because of the delays caused by the long lead time needed to start the project. In addition, the Corrections bill expands the cases where the 10-year ownership requirement would be waived in order to transfer the project without losing the credit. Another change in the Corrections bill that would be of great assistance is setting the credit percentage at the time of commitment for credit authority rather than when the project is placed into service. The amount of the credit is a crucial figure in the financial planning of the project. The credit in 1987 was established for the year. However, for subsequent years, it is established on a monthly basis. Therefore, to know what it will be at the time of commitment will give mortgage bankers all of the financial facts.

RECOMMENDATIONS

MBA believes there are a number of changes that could be made to improve the tax credit. MBA supports:

- A waiver of the 10-year ownership requirements for low-income housing projects that are in danger of falling out of inventory because of physical deterioration or conversion to other uses. A transfer of ownership, without penalizing the seller by recapturing the tax credit, to an owner who would maintain the project as low-income would preserve existing inventory. MBA members who have financed federally assisted or insured projects through state housing agencies are concerned about this potential loss.

- Changing the credit percentage that is established on a monthly basis to one that is established on a yearly basis. This would provide certainty during the financial planning stage.

- Development of an efficient secondary market for loans made on projects using the low-income tax credit.

- Longer authorization to encourage investors to utilize the program. There are start-up costs associated with familiarization with the program. Potential users of the program will not incur these costs for a program that is not going to be in existence very long.

MBA appreciates this opportunity to present its views and would be happy to provide further information as requested.

STATEMENT OF THE
NATIONAL ASSOCIATION OF HOME BUILDERS
before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
of the
U.S. HOUSE OF REPRESENTATIVES
on
LOW-INCOME HOUSING TAX CREDIT

Mr. Chairman and Members of the Subcommittee:

The National Association of Home Builders (NAHB), which represents more than 150,000 members involved in the building industry, is pleased to have the opportunity to submit a statement for the record on low-income housing tax credits.

Affordable rental housing, particularly for low-income families, must be a part of our nation's overall housing and social policy. We must provide tax and other incentives, which allow individuals and families who are unable to own their own homes the opportunity to live in decent and affordable rental housing.

A recent study done by the Joint Center for Housing Studies (Harvard University) underscores just how serious a housing problem this nation has, particularly among low-income households. Major findings of that study include the following:

- While the quality of America's housing stock has improved dramatically over the past 40 years, 4.5 million owners and 5 million renters still live in substandard housing. Inadequate housing is more prevalent in inner cities and outlying rural areas, places with high concentrations of low-income households. One in four young single-parent renter households with children lives in inadequate housing.

- Rental housing is home to rising numbers of the nation's poorest households as well as to an increasing share of the nation's children. The median income of young single-parent renter households with children actually declined in real terms from $10,965 in 1974 to $7,271 in 1987, while their numbers nearly doubled from 1974 to 1987.

- Since 1981, gross rents for a representative rental unit have risen 14 percent faster than prices generally, reaching a median level of $364 in 1987. Inflation adjusted rents today are at their highest level in two decades.

- While the number of vacant rental units rose from 1.54 million in 1981 to 2.66 million in 1986, 90 percent of the increase in vacancies was in units renting for more than $300 a month, well beyond the means of most low-income households. Meanwhile, the total number of units renting for less than $300 a month declined by nearly one million units between 1974 and 1983.

- Only 28 percent of renter households with incomes at or below the poverty level live in public housing or other federally-assisted housing units. This implies that 5.4 million households are left to compete for the dwindling supply of low-cost rental housing available in the unsubsidized market.

- Over the past 20 years, rents as a percent of income have increased sharply for a wide range of households. The rent burden has become particularly onerous for single-parent families, which have seen their rents increase from 34.9 percent of their incomes in 1974 to 58.4 percent in 1987.
- The burden of rising rental payments particularly among young, single-parent families, has contributed to the rising incidence of homelessness in the United States.

Since 1981, the tax incentives that were designed to encourage the production of decent, affordable rental housing have been cut back sharply or eliminated. Prior to enactment of the Tax Reform Act of 1986, investment in low-income housing was uniquely favored. Depreciation was allowed over a 15-year period on an accelerated basis. Expensing was allowed for construction period interest and taxes. Low-income housing rehabilitation expenses could be amortized over a short period. An exclusion was provided for capital gains. There was no limitation on so-called passive activity losses.

The Tax Reform Act of 1986 substantially reduced the attraction of investment in low-income housing by among other things:

- Substantially restricting the deduction of losses from "passive" activities;
- Limiting deductions for investment interest;
- Repealing rapid amortization of low-income housing rehabilitation expenses;
- Substantially lengthening allowable depreciation lives (27-1/2 years/straight-line for residential rental property);
- Substantially restricting the issuance of multifamily industrial development bonds; and
- Substantially strengthening the minimum tax provisions.

NAHB believes that the tax credit for low-income rental housing was one of the few highlights to come out of the Tax Reform Act of 1986. This provision indicates, at least, that Congress recognized the Tax Code as a tool for providing low-income housing. Although the final product was far from perfect, the enactment of the credit indicated Congress' belief that a tax incentive must be provided to encourage construction, rehabilitaation and maintenance of low-income housing. The technical corrections legislation introduced last year in both Houses offer steps to making the tax credit more workable, but more must be done.

As previously pointed out, prior to the Tax Reform Act of 1986, there were several incentives for investment in rental housing. Most of these incentives were provided by the Economic Recovery Tax Act of 1981. The 1981 Tax Act stimulated the highest level of production of rental units in a decade. This increased the availability of rental units throughout the nation. As a result of the sharp curtailment of tax incentives for investment in rental housing by the Tax Reform Act of 1986, production of rental housing has suffered. For example, 1987 saw a drop of nearly one-half in rental unit construction as compared to 1985 and 1986. Recent permit statistics indicate that this drop in construction of rental units will continue into the future.

While the low-income housing tax credit was a step in the right direction from a standpoint of encouraging production, it is fraught with several problems. A major problem is its complexity. Many investors are wary of taking advantage of the credit simply because of its complex nature. Other problems result from the credit`s interaction with the passive activity loss rules, which limit, sharply, the tax incentives that may be derived by an individual investor from the credit.

A major problem with the tax credit for low-income housing is its interaction with the passive activity loss restrictions. In general, these restrictions limit the availability of tax credits attributable to investment in passive activities to tax liability resulting from passive activity income. Individuals whose adjusted gross income is $200,000 or less are entitled to a deduction-equivalent of $25,000, thus, producing a maximum credit, unrestricted by the passive loss limits, of $7,000. This special allowance, however, phases-out for incomes between $200,000 and $250,000. Furthermore, for an individual investor to claim the maximum credit from an investment in low-income housing, his or her income must not increase beyond $200,000 for 15 years from the date of the initial investment. (Regular corporations, of course, may take unlimited credits from investments in low-income housing, subject only to the general limitation on business tax credits.)

In order to attract individual investors to low-income housing, more must be provided in the way of tax incentives. Ideally, investments in qualifying low-income housing should be exempt from the passive activity loss restrictions. However, there are several improvements that can be made short of an outright exemption from the passive loss limits. For example, the passive loss limits could be lifted for purposes of the regular tax but a portion (e.g., 50 percent) be included in the minimum tax base. Furthermore, the individual adjusted gross income limit for maximum use of the credit could be lifted. Allowing the maximum credit to be utilized only by individuals whose adjusted gross income is $200,000 or less restricts the flow of money into low-income housing. It also complicates the structure of low-income housing development, because relatively large numbers of individual investors must be found in order to attract sufficient dollars to the investment, and high syndication fees may be required to put a sufficient number of investors together.

So long as there are means of assuring that high income individuals cannot "zero out" their tax liability through investments in low-income housing, there does not seem to be any point in limiting the maximum utilization of the credit to individuals below a specified income level. Furthermore, the credit already is limited by a state volume cap. However, if Congress deems it proper to retain an income limit, then the limit should be relevant only in the year of the initial investment, rather than having to be met over the life of the investment. This would remove a major impediment, since it would assure an individual, absent other problems such as failure to continue to meet the set-aside requirements, that he or she would be entitled to annual credits throughout the life of the project.

There are several other aspects of the low-income housing tax credit that should be addressed in corrective legislation. For example, the 1989 sunset date should be removed and the credit should be extended indefinitely. Such action is needed for Congress to show its commitment toward addressing the long-term housing needs of low-income families, and to continue attracting much needed capital to low-income housing.

Furthermore, the present two-tier structure of the credit, under which non-federally subsidized projects are entitled to a more generous credit than federally subsidized projects should be eliminated. This would recognize the fact that federal housing programs need a combination of direct subsidies and tax incentives in order to be viable.

Finally, credit allocations should be permitted to be carried over from one year to the next so long as construction of a project which has been allocated credit authority begins no later than the year following the credit allocation year. This would recognize the fact that multifamily housing construction is often subject to unforseen delays.

As important as it is to continue, an improve, tax incentives to encourage production of low-income housing, it also is important to consider tax incentives for the preservation of existing low-income housing stock. In this regard, we would invite your attention to a report issued by the National Housing Preservation Task Force, on February 15, 1988. This report, entitled "The Preservation of Low and Moderate Income Housing in the United States of America," contains many sound ideas.

Regarding the role of tax policy in preserving the stock of low-income housing, the above-cited report makes the following recommendations:

- The owner of a project eligible for prepayment should be permitted to re-establish the depreciable tax basis of the project at an amount determined by the project's appraised market value at its highest and best use. In return, the owner would have to agree to maintain the project as low- and moderate-income housing until the original maturity of the mortgage. An owner agreeing to such a "lock-in" should be permitted to use 65 percent of tax losses generated by the project to offset other income, without regard to the passive loss restrictions.
- Owners of existing projects should be permitted to qualify for low-income housing tax credits, without regard to when ownership of the property was obtained.
- The sale of a limited-dividend, low- and moderate-income housing project to a public entity or non-profit organization should be treated as a nontaxable event, if the sale has taken place prior to mortgage prepayment and if the purchaser agrees to continue the low- and moderate-income character of the project.

Many of these concepts are contained in H.R.3663, which would also provide additional depreciation deductions to owners of low-income housing if they agree to maintain the property as low-income property for a specified period of time, and make certain other modifications to the low-income housing credit and the rules relating to cooperative housing corporations. We are encouraged by the introduction of this bill because it recognizes the role that tax incentives could play in the preservation of our nation's low-income housing stock.

In conclusion, NAHB appreciates the opportunity to submit this statement for the record. We want you to know that we desire to be a serious party in the dialogue concerning the steps that can be taken through the Tax Code, within existing budgetary constraints, to encourage the production and maintenance of low-income housing.

STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS

LOW-INCOME RENTAL HOUSING

The NATIONAL ASSOCIATION OF REALTORS® welcomes the opportunity to present its comments with respect to a variety of issues surrounding the state of low-income housing in this country, including the viability of the low-income housing credit enacted as part of the Tax Refrom Act of 1986, the concerns that exist regarding the continued availability of existing housing for low-income families when current compliance periods requiring low-income tenancy expire in the next several years, and the need for new construction of more low-income housing to address the growing problem of the homeless in this country. We also will comment on two bills of particular interest in this area, H.R. 3663, introduced by Chairman Rangel and Representative Frank, and most recently, S. 2115, introduced by Senators Danforth and Mitchell, and Chairman Rangel and Representative Kennelly.

The NATIONAL ASSOCIATION OF REALTORS® is a trade association consisting of approximately 775,000 members with business interests in virtually every phase of real estate, including the sale, development, appraisal, syndication, management, brokerage, ownership, and rental of real estate. The largest affiliate of the NATIONAL ASSOCIATION OF REALTORS®, the Institute of Real Estate Management (IREM), is comprised of members that operate a substantial percentage of the units currently being occupied by low-income tenants under Sections 8 and 236 of the Housing Act and Section 515 of the Farmer's Home Administration Program.

Summary of Recommendations

To summarize our primary recommendations to this Subcommittee which are discussed in detail below, the NATIONAL ASSOCIATION OF REALTORS® reccommends that the following legislative action be taken to address the acute problem of low-income housing; first, that the Congress pass and the President sign into law the provisions contained in the Technical Corrections legislation that correct or ameliorate several flaws that impair the feasibility of the low-income housing credit; secondly, the credit, which is scheduled to expire at the end of this year, be extended and made permanent; and thirdly, that added incentives should be created to assure that the existing housing stock is adequately maintained for use by low-income families and that new construction of low-income facilities is undertaken to address the growing problem of the homeless.

While the NATIONAL ASSOCIATION OF REALTORS® is not wedded to any particular approach on this subject, examples of bills that should be given serious consideration by Congress include H.R. 3663, introduced by Chairman Rangel, to assure that existing housing for low-income families continues to be operated for their benefit and S. 2115, which lifts various limitations on the availability of the low-income credit under the passive loss limitation, thereby expanding the market for investors in low-income housing properties.

H.R. 3663

H.R. 3663, introduced by Representatives Rangel and Frank (D-MA), is designed to provide sufficient incentives to assure that the existing low-income housing stock remains low-income housing and that the properties are adequately maintained. The incentives provided under H.R.3663 are as follows: first, if an existing owner of low-income property agrees to operate the property under current restrictions imposed by a Federal, state, or local housing program for an additional twenty years and to make any capital contributions that an appropriate governmental official deems necessary to restore the project to sound physical and financial condition, then the owner can increase the adjusted basis in the property to the original acquisition cost, plus the amount of any expenditures for capital improvements that were incurred before the date on which the owner agrees to continue to use the property for the benefit of low-income occupants. The additional basis allows the owner to receive added depreciation deductions or to claim the low-income credit in certain cases and also reduces the amount of gain on disposition of the property; secondly, if more than ten years have elapsed since the property was placed in service, the property can qualify for the low-income housing credit using the restored basis as described above. Moreover, the bill would allow waiver of the requirement under the low-income housing credit that the building must have been have placed in service at least ten years before it was acquired by the taxpayer if the building has been substantially assisted, financed, or operated under a Federal, state or local housing program and either the governmental official deems that a waiver is necessary to avoid foreclosure or the property is acquired as the result of a default; thirdly, if a property owner sells a low-income project to certain designated purchasers who agree to operate the property for the benefit of the low-income tenants, then the owner is allowed to exclude from the amount of gain realized on the sale an amount equal to the excess of the indebtedness on the property over its adjusted basis. Generally, the result of this exclusion is that the owner will only be taxed to the extent of any cash or consideration received from the sale. H.R. 3663 would also impose various penalties on owners who convert the properties to a use other than for low-income tenants.

The NATIONAL ASSOCIATION OF REALTORS® applauds the efforts of Representatives Rangel and Frank in fashioning legislation that addresses the most immediate concern of those seeking to find a solution to the low-income housing problem in this country: the apprehension that existing low-income properties will not continue to be operated for the use of low-income tenants. While there is a growing need for the construction of new facilities to accomodate the increasing number of homeless people in this country, the more acute and immediate focus should be on preserving and maintaining the existing housing stock. The concerns are that the twenty year compliance period for many Section 236 and other low-income housing projects constructed or acquired in the 1960s are about to expire. When that compliance period ends, project owners may prepay the existing mortgage and operate the properties free and clear of any further restrictions. Under that scenario, low-income project owners could convert the properties to rental units at fair market rents, thereby forcing many low-income tenants out of their homes and increasing the homeless population in this country. The NATIONAL ASSOCIATION OF REALTORS® believes that the approach taken by Representatives Rangel and Frank in introducing H.R. 3663 is a necessary first step in providing the needed incentives for existing low-income property owners to retain the use and management of the property for benefit of low-income families.

However, the NATIONAL ASSOCIATION OF REALTORS® believes that certain modifications should be made to H.R. 3663 to assure that it acheives its desired goals. One modification that we would recommend involves permitting owners who agree to continue to operate the property as low-income for an additional period of time to exempt their tax deductions and credits on the restored basis from the passive loss limitation under both the regular tax and the AMT. This proposal is consistent with a recommendation appearing later in our statement that the most significant revision to the viability of the low-income credit would be to exempt the credit from the passive loss limitation under both the regular tax and the AMT. Secondly, a provision in H.R. 3663 would require certain government officials to mandate capital contributions by low-income owners who agree to extend the use of the property for the benefit of low-income tenants if the property is found to be in an unsound or deteriorated condition. We believe that the process by which this determination is made needs to be more precise and more clearly targeted. Clear, discernable, and objective standards should be established in the legislation to assure that the condition of the property is significantly improved, although we would not recommend that a per unit expenditure be mandated as a prerequisite to qualification under H.R. 3663.

The Low-Income Tax Credit (Section 42)

The low-income housing tax credit contained in section 42 of the Internal Revenue Code was adopted as part of the Tax Reform Act of 1986. The credit, which replaced various tax incentives that existed under prior law for investments in low-income housing, became the centerpiece of the nation's policy for the preservation and construction of low-income housing, together with certain tax-exempt financing provisions. The question now is whether the credit serves as an adequate substitute to achieve the country's needs in providing housing to families with low to moderate incomes.

Prior to passage of the low-income housing tax credit in 1986, the legislative framework to provide incentives for the construction of new housing for low-income families and to assure the preservation of existing housing for such families represented a combination of direct subsidies under programs administered by either the Department of Housing and Urban Development or the Farmer's Home Administration and numerous tax incentives to attract private capital to the low-income housing market. The direct subsidy programs consisted generally of loan subsidies and mortgage guarantees under Sections 8 and 236 of the Housing Act administered by HUD and through Section 515 administered by the Farmer's Home Administration. These programs reduced the debt service to owners of low-income projects. In exchange for the loan subsidies, the landlords of low-income properties were prohibited from charging rents in excess of 30% of the tenant's income and were limited on the yields that could be realized from their cash investments in certain low-income projects. The tax incentives available prior to the 1986 Tax Bill involved an array of different provisions: current deductibility of construction period interest and taxes with respect to the development of low-income housing; favorable rules regarding the recapture of deprecation on the sale of low-income properties; tax-exempt financing for the construction of low-income facilities; and depreciation rules considerably more favorable than was available for other forms of real estate.

Because Federal budget cuts during the past seven years have drastically reduced the level of direct Federal subsidies administered by the programs listed above, the tax credit for low-income housing contained in the 1986 Tax Reform Act has become, either consciously or inadvertently, the centerpiece of the Nation's housing policy for the preservation and construction of low-income housing.

The basic mechanics of the credit are that a tax credit may be claimed by the owners of newly constructed, rehabilitated, and newly acquired existing low-income housing. The credit is amortized over ten years beginning with the year in which the property is placed in service (or with the succeeding year at the election of the owner). The percentage of the credit varies depending upon several factors: whether the owner has obtained any financial assistance from Federal subsidies; if the property is new or existing; and the level of rehabilitation expenditures incurred by the owner. If the property is newly constructed or more than $2,000 per unit is incurred by the owner in rehabilitating the units, then the credit is equal to a present value of 70% of the costs of qualified expenditures incurred by the owner. If the structure is an existing low-income housing facility, Federal assistance is obtained by the owner, or the costs of rehabilitating each unit are less than $2,000, then the amount of the credit is reduced to equal a 30% present value. The credit amount is based on the percentage of the units being occupied by low-income tenants. The amount of the credit after 1987 will be adjusted monthly to achieve a present value of either 70% for newly constructed or rehabilitated buildings, or 30% for existing buildings and all Federally-subsidized structures.

Low-income tenants are defined as tenants having incomes equal to or less than either 50% or 60% of the area median income adjusted for family size. The qualifying income for a particular property depends on the minimum percentage of housing units that the owner selects for low-income tenants. The owner may not charge rents to low-income tenants in excess of 30% of the applicable income adjusted for family size. To qualify for the credit, the owner must agree that the low-income housing project will continuously comply with all requirements as a low-income facility for a period of fifteen years.

Under the credit provision, each state receives an annual credit volume allowance of $1.25 per resident. A credit allocation from the appropriate state or local government credit authority must be received by the owner of property eligible for the low-income housing tax credit, unless the property is substantially financed with the proceeds of tax-exempt bonds subject to the state's private activity bond volume limitations. Unless extended, the credit will expire on January 1, 1989, except for certain projects that have commenced prior to that date.

Most significantly, while there are certain preferential exceptions accorded the credit under the passive loss rules, the credit, nevertheless, is subject to the limitation. Under existing law, a taxpayer can obtain up to roughly $7,000 in tax credits from an investment in a low-income property (even if held by a limited partnership) that are exempt from the passive loss rules provided his adjusted gross income does not exceed $200,000. The credits will begin to phase-out at $200,000 of AGI and are totally eliminated once a taxpayer's AGI reaches $250,000. These limitations (both amount and income ceiling) make investments in low-income housing unattractive for high-income investors, who over the years have been the primary source of private capital for low-income housing in the country.

Problems Involved in Utilization of the Credit

Background

Although the legislative history surrounding adoption of the low-income housing credit in 1986 is ambiguous regarding whether the credit was intended to provide sufficient incentives standing alone for investment in low-income housing, the experience with the low-income credit since 1986 has clearly shown the credit only to be effective when supplemented by Federal, state, or local loan assistance. Stated differently, the credit by itself is ineffective in providing ample incentive to attract the requisite capital for investment in low-income housing. Moreover, while the low-income credit has been used with some success to rehabilitate existing low-income housing when augmented by financial assistance through various forms of Federal, State or Local assistance, there is scant evidence to indicate that the credit is encouraging the construction of new facilities for low-income families. A more revealing illustration of the lack of effectiveness of the low-income housing credit is the limited extent to which the credit has been used by state credit and housing authorities since its inception. According to data supplied by the National Council of State Housing Agencies, only 20% of the available low-income housing credits were utilized in 1987. Clearly, the credit must be improved if it is to be a successful instrument in achieving the nation's goals regarding low-income housing.

Proposals to Improve the Viability of the Credit

While the NATIONAL ASSOCIATION OF REALTORS® is quite sensitive to the mounting concerns over the growth of the Federal budget deficits and to the loss of revenue that major changes to the low-income housing credit would cause, nevertheless, it is abundantly clear that action needs to be taken as expeditiously as possible to address the dual problems of preserving the existing housing stock for low-income families, and of encouraging the construction of new facilities to avoid an increase in the number of homeless people. Although reality may dictate that new legislation providing meaninful relief cannot be passed in 1988, the NATIONAL ASSOCIATION OF REALTORS® would reccommend that the following steps be undertaken by Congress as soon as possible:

1. Enactment of the Technical Corrections Legislation.

The Technical Corrections legislation, which was originally included in H.R. 3545 but was deleted at the last moment, contains several provisions that would facilitate the efficiency and effectiveness of the low-income housing credit. The NATIONAL ASSOCIATION OF REALTORS® strongly supports passage of these provisions as a first step in improving the workability of the low-income housing credit. One provision would correct a problem that presently exists with respect to the allocation of credit authority to a state in which a building is placed in service in a subsequent year. Because the current tax credit does not allow states to carry over unused credit authority ($1.25 per resident), a building that was placed in service in a subsequent year could cause the state to exceed its credit authority for that year. Under the Technical Correction provision, a state would be permitted to elect to carry over unused credit authority for projects that are specifically identified. The state's credit volume limitation in those situations would be reduced from $1.25 per resident to $1.10.

A second provision would provide that the determination of whether a tenant's income qualified as low-income could be made with reference to the higher of the area median income or the state median income. This modification will slightly increase the yield to low-income owners, thereby enhancing the financial incentive for a developer to acquire or rehabilitate a low-income project.

Other significant provisions contained in the Technical Corrections legislation will permit the owner of a low-income housing project to disregard changes in family size resulting from death, divorce, separation, and abandonment in determining the gross rent which may be charged an existing low-income tenant. Certain exceptions were also provided from the ten year anti-churning rule for certain Federally-subsidized housing if the Secretary of the Treasury determined that failure to grant a waiver would result in the property not being used for low-income housing. And, the Technical Corrections bill would have excluded rental assistance payments under Section 8 from gross rent in determing whether a project qualified for the special set aside for tenants who cannot be charged in excess of one-third of the rent charged to non low-income tenants.

2. Proposals For Improving the Effectiveness of the Low-Income Tax Credit

The segment of the membership of the NATIONAL ASSOCIATION OF REALTORS® which has had experience working with the low-income housing credit has made several suggestions that would enhance the effectiveness of the low-income housing credit. These suggested modifications are as follows:

a. Proposals to Modify or Remove the Restrictions Imposed on the Availability of the Credit to Investors Under the Passive Loss Limitation

Present law restricts the availability of the low-income housing credit to investors whose adjusted gross incomes do not exceed $200,000. If this threshold is exceeded, the credit begins to phase out and is totally eliminated at $250,000 of adjusted gross income. Consequently, investments in low-income housing projects qualifying for the credit have largely been the province of corporate investments, which generally are able to utilize the credit without limitation under the passive loss rules. Moreover, because the credit is amortized over a ten year period, an individual investor whose income is expected to rise, is faced with the prospect of having a portion or all of his credit disallowed due to the income ceiling during the ten year period even though his income was below the $200,000 threshold in the year the property was placed in service. This factor can deter substantial investments in low-income properties by high-income individuals, who represented one of the primary sources of private investment in low-income housing prior to the 1986 Tax Reform Act. The segment of the membership in the NATIONAL ASSOCIATION OF REALTORS® that has had practical experience working with the new low-income housing credit has stressed that the most important change that could be made to improve the workability of the credit would be to exempt the credit altogether from the passive loss limitation under both the regular tax and the alternative minimum tax. This approach would expand the available market by allowing the credit to be fully utilized by high-income investors who would be attracted in far greater numbers to invest in low-income housing projects.

While an exemption for the low-income housing credit from the passive loss limitation under both the regular tax and the alternative minimum tax (AMT) represents a bold departure from the tax policy principles enunciated in the Tax Reform Act of 1986, the NATIONAL ASSOCIATION OF REALTORS® believes that the policy objective in this country of providing adequate housing for low-income families is a priority that overrides tax policy considerations. Unlike other investments in real estate, low-income housing is not profitable in its own right and must offer added incentives to attract the requisite capital. When viewed in this light, an exemption from the AMT passive loss provision also can be justified on the grounds that retaining the passive loss limitation for AMT purposes greatly undermines the incentive for the high-income investor who is likely to be subject to the AMT. If an investor is subject to the AMT, the value of the credit is diminished to such an extent that it would discourage most high-income investors from making the investment.

A recent draft of the National Housing Task Force appointed by Senator Alan Cranston (D-CA) recommends as one of its policy objectives that the low-income housing credit should be exempt from the passive loss limitation under the regular tax and the AMT. In support of its recommendation, the report cites the fact that low-income housing must offer additional incentives to attract the necessary private capital.

Most recently, Senators Danforth and Mitchell, together with Representatives Rangel and Kennelly, among others, introduced S. 2115, which would accomplish the recommendation of the National Housing Task Force, although it would also exempt the rehabilitation tax credit from the passive loss limitation. S. 2115 would exempt both the low-income credit and the rehabilitation tax credit from the passive loss limitation for the regular tax, but not under the alternative minimum tax (AMT).

To reiterate, the NATIONAL ASSOCIATION OF REALTORS® believes that the balance that exists between tax policy and low-income housing objectives should be tilted in favor of the compelling need for greater incentives for investments in low-income housing. Accordingly, we believe that a taxpayer should be allowed to apply the low-income credit against the AMT, while retaining the tighter limitations on the use of the general business credits under S. 2115. The proposal would also eliminate the income ceiling which prevents many high-income taxpayers from investing in low-income projects and removes the restriction limiting the amount of credits that a taxpayer can claim for investments in low-income properties to approximately $7,000. However, as a means of reducing the cost of the proposal in terms of foregone revenue to the Treasury, S. 2115 subjects both the low-income and rehabilitation tax credits to the limitations imposed on the use of general business credits and further tightens those rules. In particular, the proposal would limit the amount of credits allowable to an individual to the first $20,000 of the taxpayer's net tax liability plus 20% of the liability in excess of $20,000. S. 2115 also makes investments by tax-exempt organizations in low-income housing and rehabilitated structures more attractive by making several modifications, including allowing the credit to offset any unrelated business income tax liability, exempting tax-exempt organizations from the tax-exempt entity use restrictions, and by clarifying that interest income foregone on below market loans to tax-exempt organizations operating qualified low-income housing can be treated as a qualified distribution under the payout rules for private foundations.

The NATIONAL ASSOCIATION OF REALTORS® supports the general thrust of S. 2115 in expanding the market for investments in low-income housing by removing the limitation under the passive loss rules for low-income investments. However, while NAR is generally quite supportive of the goal of preserving historic and older structures which the rehabilitation tax credit encourages, we would suggest that the acute problems of preserving the existing low-income housing stock and providing housing for homeless families warrant a more immediate response than does the rehabilitation tax credit and that the two issues should be addressed separately.

There are a number of other proposals more modest than a total exemption from the passive loss limitation under both the regular tax and the AMT that could enhance the viability of the low-income credit. One approach would simply lift the income ceiling ($200,000 - $250,000) for high-income investors, thereby enabling them to claim up to $7,000 in tax credits, while retaining the current disallowance of the credit against the AMT and the ceiling of $7,000 on the amount of credits that can be claimed. A second proposal would reduce the disparity in the amount of the credit percentage between the credit available on nonsubsidized low-income housing and subsidized low-income housing. Because most low-income housing projects that are currently undertaken utilizing the low-income credit involve some form of Federal, state or local financial assistance, the rationale would be to concentrate a higher percentage of the credit on those types of projects that are actually being done by developers. For example, the current 9% credit for nonsubsidized, new construction or substantial rehabilitation could be reduced to 8% or 7% while the credit for subsidized rehabilitations and acquisitions could be increased to 5% or 6%. A third approach would be to amortize the credit over a shorter period of time such as five years instead of the longer ten year period under present law.

3. Extend the Low-Income Credit Beyond its Current Expiration Date and Make it Permanent.

The existing credit for low-income housing expires in 1990 except for projects that are in process after that date and are placed in service by January 1, 1991. While there are other transitional rules adopted as part of the 1986 Tax Reform Act that allow properties placed in service before January 1, 1991, to qualify for the credit if certain criteria are met, the basic sunset rule for the low-income credit will mean that most acquisitions or rehabilitations of low-income properties must be undertaken before 1989, unless the credit is extended. Clearly, the current provision requiring that the credit be sunset by the end of 1988 causes uncertainty in the planning decisions of many developers who would otherwise be interested in undertaking rehabilitations or acquisitions of low-income properties. Consequently, Congress should act expeditiously to extend the credit beyond 1988 and to make it permanent.

4. Remove the Restrictions Imposed on the Cash Flow Returns of Low-Income Owners.

Many existing low-income properties (Section 236) impose restrictions limiting the yield from the cash invested in the projects. For example, Section 236 limits the yield on cash invested in the low-income structure to a 6% return. In order to provide incentives for low-income owners to continue to operate projects under Section 236 and other subsidy programs for the benefit of low-income tenants, the NATIONAL ASSOCIATION OF REALTORS® would recommend that the restriction on the yield from cash investments be lifted. A modification of this nature would only enhance the attractiveness of low investments to developers in existing low-income properties. Moreover, in light of the restriction that presently exists under the low-income credit limiting the gross rents paid by families in low-income units to 30% or less of their qualifying income, a proposal to lift the restriction on the return from cash investments would not cause an additional burden for the low-income occupants.

Conclusion.

The NATIONAL ASSOCIATION OF REALTORS® commends Chairman Rangel and other members of the Select Revenue Measures Subcommittee for holding this hearing on the vital issue of addressing the country's needs for the preservation of existing low-income housing and the construction of new facilities. While we believe that the issue of providing incentives for the construction of new facilities an important policy issue that must be addressed imminently if the homeless problem is to be favorably resolved, we do believe that the more compelling need is to devise legislation that will meet the more immediate problem of preserving the existing housing stock for low-income families and assuring that these facilities will continue to be owned and operated for their benefit. While we are sensitive to ongoing Federal budgetary deficits and concerns, we believe that steps need to be taken in the short run to adequately deal with this problem, or, inevitably, the result will be that the price tag to the Federal government of devising an acceptable solution later will only be compounded. We stand ready to work with the Congress and this Administration or the next one in helping to shape an adequate and responsible solution to the problem of providing housing for families of low and moderate incomes.

NCBA
National Cooperative Business Association

March 16, 1988

The Honorable Charles B. Rangel
Chairman, Subcommittee on Select
Revenue Measures
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rangel:

On behalf of the National Cooperative Business Association, I would like to express support for enactment of the Low Income Housing Tax Act of 1987, H.R. 3663. I would appreciate if you would submit this statement for inclusion in the record of public hearings held on March 2 and 3 on this legislation and other proposals to use tax policy to preserve our nation's low income housing stock.

The National Cooperative Business Association (NCBA), founded in 1916 as the Cooperative League of the USA, is a national membership and trade association representing America's cooperative business community. NCBA's membership includes farm supply, agricultural marketing, insurance, banking, housing, health care, consumer goods and services, student, credit union, worker, fishery, rural electric and telephone, state associations and other types of cooperatives.

NCBA's diverse membership comprises four tiers of cooperative organizations: national, regional, state and local organizations. These tiers are represented in each of several membership sectors and personify the one in five Americans who belong to a cooperative.

NCBA's housing sector includes housing cooperatives and professional housing organizations committed to the development of cooperative housing. Several levels of organizational involvement are evidenced through the membership of such groups as the Association of Housing Cooperatives, the Council of State Housing Agencies, the National Corporation for Housing Partnerships, the Massachusetts Cooperative Task Force, the New York Council of Cooperatives, and Greenbelt Cooperative Homes.

NCBA supports the development and expansion of cooperative business in the United States and in lesser developed countries; represents the cooperative business community before Congress, governmental bodies and other national and world organizations; and promotes international commerce, banking and joint ventures by and among the world's cooperatives. NCBA's housing program encourages the development and successful operation of housing cooperatives in

Representing America's Cooperative Business Community

National Cooperative Business Center
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the United States through legislative advocacy, education and training, development services and public relations work. In recent years, NCBA's housing program has emphasized senior and affordable cooperative housing development.

NCBA supports the use of federal tax policy to preserve our country's previous stock of low income housing. We commend you and Representative Frank for your leadership in this important area.

We also would like to commend you on your recognition of cooperatives as an affordable housing resource. It is a true but little known fact that cooperative housing is predominantly owned by low and moderate income families. The unique legal and financing structure of a housing cooperative facilitates affordability, for it allows for project financing, the use of project and member-based subsidy, resale price controls, non-profit operation and accumulation of financial reserves.

NCBA supports Sections 5 and 6 of this legislation which would strengthen the financial condition of limited equity housing cooperatives. We recommend limited-equity structures to ensure permanent housing affordability. However, we concur with the National Association of Housing Cooperatives in recommending that these provisions be broadened to include housing cooperatives which may not impose resale price controls but still serve moderate income families. In addition, we urge the subcomittee to expand its definition of member income under Code Section 216 to include interest from the investment of reasonable reserves; subsidies, grants, and similar forms of income; and insurance proceeds earmarked for reinvestment.

As part of an overall package to preserve the low income housing stock, Section 5 and 6 of the bill are appropriately focused. However, we urge the subcommittee to examine the broader issue of the applicability of Section 277 to housing cooperatives. Until this issue is clarified legislatively or in the courts, we strongly urge the subcommittee not to infer Section 277's applicability in this legislation or related report language.

Thank you for this opportunity to submit our views. Please let us know if we can be of any assistance as you proceed with this legislation.

Sincerely,

Barbara

BARBARA J. THOMPSON
Vice President for Housing Development

BJT:emd

STATEMENT OF THE NEW YORK STATE MORTGAGE LOAN ENFORCEMENT AND ADMINISTRATION CORPORATION

This statement is made on behalf of the New York State Mortgage Loan Enforcement and Administration Corporation ("MLC") by Kyllikki Kusma of Brownstein Zeidman and Schomer (Washington, D.C.) and addresses the problem of maintaining the stock of governmentally-assisted low-income housing, and the important role which the Internal Revenue Code of 1986, as amended ("Code") can and should play in preserving the low-income housing.

MLC is a state run agency under the auspices of the Urban Development Corporation which is responsible for $1.2 billion dollars of subsidized, low income housing loans originated by the New York State Urban Development Corporation. Most of this housing was built pursuant to the HUD-assisted but uninsured Section 236 Loan Program that carries low rates of interest. Many of these uninsured project mortgages have experienced financial problems and currently have debt service arrears in excess of $158 million. To make needed repairs to maintain these facilities and to avoid foreclosure, these projects need to attract investors who are willing to contribute cash and assume ownership and operation of the property. The infusion of capital enables the owners to make the capital contributions and improvements required to stabilize the operation of the properties and to attract tenants so that the cash flow from the property will become sufficient to meet its operation costs, including debt service, normal operating expenses and repairs. Unfortunately, the adoption of the Tax Reform Act of 1986 ("TRA") has had a significantly adverse impact on the ability of MLC and others interested in preserving low- and moderate-income housing to attract necessary capital to maintain the projects in a decent, sanitary condition and pay basic operating expenses.

The inability to raise needed capital will result in further deterioration of this valuable housing stock which cannot be replaced at any reasonable cost. The elimination of federal housing programs for low-income tenants and huge increases in the cost of producing these units have made the maintenance of the valuable assets which are represented by these existing projects all the more imperative. It makes no sense not to preserve these valuable housing units.

New York State is large and diverse and made up of significant urban and rural areas. The result is that the problems faced by New York reflect the diverse problems of creating and maintaining housing throughout the country. The varying costs, needs and peculiar circumstances facing the needy throughout New York support the general notion that significant and flexible responses to the problem of maintaining affordable housing must be pursued at the federal, state and local levels.

New York State has never shirked its responsibility to be in the forefront of developing and maintaining housing for low- and moderate-income peoples. Well before the policies of the current Administration directed more and more responsibility for housing reduction and maintenance to the states, New York State had made significant and innovative contributions to the cause of producing and maintaining its low-income housing stock. That commitment has increased dramatically in recent years with programs from state and local levels committing hundreds of millions of dollars of state and local funds to this effort.

LOW-INCOME HOUSING CREDIT

The task and the cost of housing, however, is one which cannot be borne by the states and localities alone. This fact clearly was recognized by the Congress in connection with the adoption of the TRA in at least one respect. While the devastating impact on rental housing was clearly felt in the context of changes to the laws relating to the treatment of passive losses and the extension of depreciation with respect to rental property, the adoption of the low-income housing credit ("low-income credit") signaled a continuing federal concern and commitment to housing of low income Americans. We commend this continued commitment but our concern is that the credit needs to be amended to meet the needs of low income renters. A summary of these changes follows.

I. CARRY-OVER

Section 42(h)(6)(B) of the Internal Revenue Code of 1986, as amended ("Code"), which provides that unused credit allocation cannot be carried over to any other year, must be amended. The inability to carry over credit creates uncertainty for both state housing agencies and project developers. Housing agencies have a limited amount of low-income credit which they can allocate in any one year. In making the allocation, they have several concerns: they do not want to over- or under- allocate the credit for a year and they want assurances that projects preliminarily allocated the credit are worthy and will be placed in service during the year. Because of delays inherent in structuring a transaction for the sale of a building and in any construction project, there is no assurance that a building will actually be placed in service for the year the agency contemplates allocating the credit. Planning is disrupted. Permitting carry-overs of credit will facilitate planning and insure that worthy projects are allocated, and actually receive, the low-income credit.

Planning considerations are equally applicable in the case of specific projects. Thus, projects also should be permitted to carry over a low-income credit allocation.

II. $25,000 PASSIVE LOSS EXEMPTION

Most of the incentives favoring low-income housing were eliminated by the TRA. The low-income credit provisions were enacted, in part, to provide an incentive for the continued construction and preservation of low-income housing. Historically, investors in low-income housing have been high income earners who have disposable income to invest and who can afford to make a large, illiquid investment that has substantial risks and no expectation of cash flow or near-term appreciation.

Under TRA, passive-activity losses can generally be utilized to offset only passive-activity income. An individual investing in low-income housing may, however, offset up to $25,000 of non-passive income from his low-income rental real estate activities regardless of whether he actively participates in such activities. The $25,000 allowance is not available, however, for wealthy taxpayers, since Code section 469(i)(3)(B) phases out the $25,000 allowance with respect to taxpayers whose adjusted gross income for the taxable year exceeds $200,000.

A $200,000 limitation essentially forecloses from investing in low-income housing the very investors who have sufficient funds for an illiquid investment and who can undertake the risk that it entails. Moreover, even if an investor has income of below $200,000 at the time of the investment, the investor would lose the ability to use the low-income credit if later his or her income increased beyond that amount. That factor alone may dissuade potential investors. The provision of low-income housing is a worthy social goal which will be easier met if the $200,000 limitation is either eliminated or increased to meet the adjusted gross incomes of investors willing to invest in low-income housing.

As an alternative, MLC would support the approach taken in the "Community Revitalization Tax Act of 1988" (S.2115 and H.R. 4048). These Bills would eliminate the low-income credit from the passive activity rules in exchange for a reduction in the amount of the general business credit which a taxpayer may claim in any taxable year.

III. SER-ASIDE REQUIREMENT

A project qualifies as a low-income project if, *inter alia*, 20 percent or more of the units are occupied by tenants whose income is 50 percent or less of area median income or 40 percent or more of the units are occupied by tenants whose income is 60 percent or less of area median income. While we understand and appreciate that relief should be targeted to serve the most needy, projects must generate enough income to enable a developer to finance the project. In areas where low median income and high construction costs combine to create burdens on housing development and operation, higher targeting is necessary to provide more income through project rents.

The Conference Agreement provides that income limits may be adjusted for areas that have unusually low family incomes or high housing costs relative to family income. The adjustments are to follow Section 8 determinations of very low-income families and area median gross income to reflect the 50 percent and 60 percent income levels. Under the authority of this section, the targeting requirements should reflect the needs of areas that have low area median incomes and high construction costs.

A formula should be established to enable high cost/low area median income areas to adjust the area median income limits established by TRA. The formula should compare local costs of multifamily housing construction, land and area median incomes, with similar national costs and incomes. The current income limits (i.e., 50 percent or 60 percent of area median income) would be used as a base. In areas where the cost of construction exceeded the national average and/or where the area median income fell below the nationwide median, the income limits could be adjusted upward. Income limits would not be reduced below levels established by TRA in areas where construction costs were lower than the national average or the area median income was higher.

The proposed formula would compare area construction costs and median incomes to such national standards. The numerator of the formula would compare area costs of multifamily housing construction with nationwide costs. The denominator would compare area median incomes with the national median income. The formula is expressed below:

$$\frac{\text{area cost of multifamily construction}}{\text{national cost of multifamily construction}} \div \frac{\text{area median income}}{\text{national median income}}$$

The concept of a construction cost index that recognizes variations in local construction costs has already been proposed for hospital capital costs. The Department of Health and Human Services (HHS) engaged Dodge Data Resources, Inc. to develop the construction cost index, and it was utilized in its regulations.

Current low-income rents are barely adequate to cover maintenance and operation costs. As a result, the capital cost of construction cannot be recouped and return on that capital is merely hypothetical. Applying the proposed formula to establish income limitations would improve the ability to finance these projects and to make them economically and financially feasible.

IV. GROSS RENT: STATE OR LOCAL ASSISTANCE

Code section 42(g)(2)(B) defines "gross rent" for purposes of setting forth the standards for a rent-restricted unit in a qualified low-income housing project. It specifically provides that gross rent does not include payments under Section 8 or any comparable Federal rental assistance program. Technical corrections should clarify that rent supplement and Rental Assistance Payment programs are "comparable Federal rental assistance programs." In addition, it is our understanding that gross rent is not to include payments under state or local assistance programs that are comparable to the Federal Section 8 program. Technical corrections should confirm this understanding. To provide otherwise would discriminate against those projects that have rent assistance under state or local programs rather than under the Federal Section 8 program.

V. DISTRESSED PROJECTS

State and local municipalities or their instrumentalities (hereinafter called "governmental units") may acquire, through the foreclosure process, projects that are currently in default. Code section 42(d)(2)(b)(ii) generally provides that there must be a period of at least 10 years between the date a taxpayer acquires a building and the date the building was last place in service. There is real concern that a governmental unit's acquisition of a project under foreclosure procedures may be treated as a placement in service. If so, the project will not be eligible for a credit allocation for a 10-year period.

Project owners view a foreclosure as a final option for a distressed project since foreclosure triggers the recapture of previously taken tax benefits and is likely to result in a Federal tax liability to the defaulting owner substantially in excess of cash, if any, distributable to such owner. Foreclosures arise under one of two circumstances. A tax foreclosure occurs when property owners do not pay their taxes and the city forecloses on the property. Foreclosures also occur when property owners do not make payments on their debt obligations. The goal of the governmental unit under either of these circumstances, is to find owners for low-income housing.

A. Acquisition by Governmental Units

Presumably, the 10-year rule was enacted to prevent abuses arising from the churning of properties. Acquisition by a governmental unit will not lead to this abuse. Governmental units are not organized to be in the business of operating rental buildings and it is not to their benefit to do so. When a governmental unit acquires a project through foreclosure, its goal is not to take the low-income credit or to make a profit, but rather, to find a buyer for the property to assure that decent housing can continue to be provided.

Concluding that acquisition by reason of foreclosure (tax or otherwise) constitutes placement in service, runs counter to the intent of providing decent affordable low-income housing. Although there is no guarantee that any project will be allocated, and actually receive, the low-income credit, properties acquired by foreclosure by a governmental unit and sold will not even be in the running unless it is clarified that acquisition by a governmental unit does not constitute placement in service.

In addition, the definition of "governmental unit" should be clarified to include corporate subsidiaries of state agencies which themselves are "governmental units" where such subsidiaries enjoy all of the privileges, immunities, tax exemptions and other exemptions of the state agency.

B. Federally-Assisted Building

Code section 42(d)(6)(B)(ii) defines a "federally-assisted building" as any building which is substantially assisted, financed or operated under section 221(d)(3) or 236 of the National Housing Act of 1934. Many housing projects are built pursuant to the HUD assisted but uninsured section 236 program. Technical corrections should clarify that projects assisted, but uninsured, under the HUD 236 program qualify as "federally-assisted building," and that different standards should not be applied to these projects.

VI. 10-YEAR HOLDING PERIOD: STATE OR LOCAL ASSISTANCE

For purposes of the low-income credit, the cost of acquisition of an existing building may be included in eligible basis only if the building has not been previously placed in service within ten years. The Treasury Department may waive the ten-year requirement for any building substantially assisted, financed or operated under HUD section 8, section 221(d)(3), or section 236 programs, or under the FmHA section 515 if the waiver is necessary (i) to avert an assignment of the mortgage to HUD or FmHA, (ii) to avert a claim against a Federal mortgage fund or (iii) by reason of other circumstances of financial distress.

Passage of Code section 42(d)(6) is evidence of Congress' recognition that federally-assisted projects should not be penalized under the credit provisions merely because financial distress necessitates their sale. The same relief, however, is not granted to state or local governmental-assisted projects that are experiencing financial distress.

As enacted, Code section 42(d)(6) places its emphasis not on the substantive issue of whether a project is financially distressed, but rather, on the source of the building's assistance. Whether a building is assisted under a federal program or a state or local program should not be the factor that determines whether a building is eligible for the 10-year holding period relief set forth by Code section 42(d)(6). In order to ensure that otherwise identical projects receiving state or local assistance are not treated differently from those receiving federal assistance, the rule should specify that state or local programs that are comparable to HUD section 8, section 221(d)(3), or section 236 programs, or the FmHA section 515 program are entitled to the relief set forth under Code section 42(d)(6).

VII. INCOME LIMITATIONS: FAMILY SIZE ADJUSTMENTS

Under the low-income credit rules, adjustments for family size are required in determining area median incomes. This requirement has a serious impact on the ability to underwrite projects. Underwriters need to project the rental income a project will generate to determine the amount of the mortgage loan the project can support; if the determination of available rental income cannot be determined until the project is rented (and the family size of the tenants determined), underwriters must assume all low-income units will be occupied by the smallest numbers of persons or families. Moreover, continued eligibility of units can be affected by changes in family size, if, for example, a family member dies, grows up and moves out or leaves because of a divorce.

The effect of annual recertification and required family-size adjustments is to place low-income households in annual jeopardy of eviction or substantial rent increases. Yet because of the very shortage of low- and moderate- income housing the program is designed to alleviate, in many areas with low vacancy rates, alternative housing is not available. The family-size income limit adjustments also substantially increase the risk of unintentional noncompliance for the owner.

The low-income credit rules should be amended to provide that family-size adjustments do not affect income eligibility.

VIII. SECTION 8 ASSISTANCE

Assistance payments under Section 8 require the gross rent paid by occupants of a low-income unit always to equal 30 percent of the tenant's income and therefore to increase as the income of the occupants increases. As a consequence, a low-income Section 8 tenant whose income exceeds the applicable low-income credit income standard (i.e., 50 percent or 60 percent of area median income) will be required to pay more than 30 percent of the applicable low-income credit standard as his rent contribution, a violation of the low-income credit requirements. The low-income credit rules should be amended to provide that the gross rent paid by the low-income tenant may exceed 30 percent of the applicable income limits to the extent such increase is required under the Section 8 program.

IX. TRANSITIONAL RELIEF

To maintain the continued ability of MLC projects to house the poor, MLC requires transitional rule relief under the low-income housing credit rules.

MLC's portfolio of low-income housing includes many projects that are severely in arrears with respect to payments of both principal and interest. Most of the projects need significant repairs and maintenance which require significant additional infusion of capital. There is a very real possibility that defaults will occur. Unless the projects can be sold, the defaults will trigger foreclosures. In addition, defaults often mean a decline in management services and other detriments to tenants.

Because so many of MLC's projects are experiencing financial distress and are not attractive to investors, special relief is needed and justified. Section 252(f)(2) of TRA granted an extra credit allocation to specified housing agencies and provided that the applicable percentage for buildings allocated the credit will be one. MLC requests that any low-income project in its portfolio that is allocated the credit be treated as having an applicable percentage of one. In the alternative, we request that this relief be granted to the projects that are most severely in arrears. By increasing the credit amount, MLC's projects will attract investors. The new influx of funds will help to preserve the existing portfolio of low-income housing.

X. EXTENSION OF SUNSET

The low-income credit is scheduled to expire at the end of the 1989 calendar year. The sunset date should be extended. The low-income credit rules were enacted in response to changes in laws relating to the treatment of passive losses and the extension of the depreciation period for rental property which made investment in low-income housing unattractive. With the sunset of the low-income credit, there would be no incentive left for investors to invest in low-income housing since it offers little current cash flow and limited appreciation.

XI. TECHNICAL CORRECTIONS ACT

Many important changes were included in the Technical Corrections Act passed by the House of Representatives last year which are critical to the effective use of the low-income credit. Those changes should be adopted at the earliest possible time.

H.R. 3663

The remainder of this statement comments on the provisions of H.R. 3663 which Congressmen Rangel and Frank introduced on November 19, 1987 (the "Bill"). The Bill, which is aimed principally to promote maintenance of low-income housing projects is an important step in the process of preserving existing housing stock.

The Bill provides incentives to the preservation of low-income housing by four general means: The basis of a qualified low-income building is restored, a certain portion of gain realized from the disposition of low-income use-restricted property is not recognized, certain buildings are eligible to use the low-income credit regardless of whether there has been a transfer to a third party, and the 10-year waiver rules are amended.

I. TEN-YEAR PLACED IN SERVICE RULE

Under TRA unless 10 years have elapsed since a building was last placed in service the low-income credit is not available even when a transfer of the property occurs unless a waiver of the holding period is received. Moreover, a project is eligible for the waiver only if it is federally-assisted and if the waiver is necessary to avoid an assignment of the mortgage to HUD or the Farmers Home Administration, to prevent a claim against a federal mortgage insurance fund or by reason of other circumstances of financial distress. This means that the credit is unavailable for a large number of low-income projects in New York State and elsewhere. The Bill makes favorable amendments to this 10-year waiver rule requirement by providing that the waiver is available for government assisted buildings if the credit is needed to enable the project to avoid default or to be retained for low income. These are significant clarifications and should be adopted.

"Government-assisted building" is defined to mean any building that is substantially assisted, financed or operated under any federal, state or local housing program. The definition should be amended to provide that "federal, state or local" includes any of their subsidiaries or instrumentalities.

II. REQUIRED SALE OF EXISTING HOUSING

The TRA provides that the low-income credit is available for existing housing stock only to the extent that the project is transferred to another owner. The Bill recognizes the need to provide low-income credit for existing properties without the requirement of the transfer and sale of the property so long as additional requirements, such as the infusion of additional capital, are satisfied. This approach ensures that more of the benefits of the low-income credit will go into the project itself and not to the costs of the transaction.

III. BASIS RESTORATION

Under the Bill, the basis of certain property can be restored if: (i) the building constitutes "qualified low-income housing," (ii) the owner enters into an Agreement with the appropriate government official (the "Agreement") under which the owner agrees to (a) continue to operate the building under the existing program restrictions for the longer of 20 years or the remaining term of any indebtedness provided (or subsidized) under the program (or, the remaining term of any Section 8 contract), and (b) make capital contributions determined to be necessary to repair and restore the building to sound physical and financial condition within 24 months of the Agreement date; and (iii) no low-income credit was taken with respect to the property for any period before the date of the Agreement.

A building constitutes "qualified low-income housing" if (i) it is substantially assisted, financed or operated under a federal, state or local housing program and is subject to restrictions on rents or income with respect to at least 20 percent of the tenants, (ii) its adjusted basis does not reflect a prior adjustment under new Code section 1061(a), and (iii) it is the subject of an agreement with an appropriate government official. The Bill should clarify that the phrase "assisted, financed or operated" does not require the project to be insured under the appropriate government program. Any housing projects receiving state, local or federal assistance but no insurance should be treated as "assisted, financed or operated" under a federal, state or local housing program.

IV. "APPROPRIATE GOVERNMENT OFFICIAL"

Under the Bill, "appropriate government official" is defined to mean the head of the governmental body primarily responsible for administering a federal, state or local housing program. The "appropriate government official" plays a significant role under the Bill since he or she has the authority to determine the amount of capital contributions required to restore a building to sound physical and financial condition and enters into the Agreement described above with the owner of the project. The definition does not provide who the appropriate official would be if a project receives assistance from more than one governmental source. The rule also fails to consider that it is at the state or local level where the programs are administered and where information regarding the projects is most readily received and analyzed. The Bill should provide that the local agency or governmental instrumentality under which the project operates should be the "appropriate government official" in all situations.

V. COMPLIANCE PERIOD

Qualification as "qualified low-income housing" is required to secure restoration of the property's basis or for the building to be eligible for the low-income credit. As drafted, the building would be required to be subject to restrictions on rents or income for at least a 20-year period. The low-income credit rules require a 15-year compliance period. The 20-year restriction period should be reduced to 15 years to eliminate the inconsistency between these sections.

VI. RECAPTURE OF BENEFITS

New Code Section 1061 (which sets forth the credit and basis restoration rules) would require recapture of its benefits if, prior to expiration of the Agreement, the owner fails to operate the qualified low-income housing in accordance with the terms of the Agreement or disposes of the housing. In addition, interest would be imposed.

These recapture provisions do not contemplate a reduction in the amount recaptured to reflect the period of time that the project was operated according to the terms of the Agreement. The owner who maintains a building according to its Agreement for 19 years of a 20-year commitment should not be treated as harshly as one who maintained a building according to its Agreement for only 5 years of a 20-year commitment.

The Code section 1250 recapture rules reduced the amount of ordinary income to be recognized with respect to low-income housing based on the number of years the property was operated according to its Agreement. Similar rules would be appropriate here.

VII. DISPOSITION OF PROJECT

One of the major problems in attempting to preserve low-income projects is the negative tax consequence which may result to existing owners who wish to dispose of these properties. The result often is that existing owners will not dispose of facilities -- which might be better maintained in the hands of a new owner -- because of concern by existing owners that the sale will trigger negative tax consequences. The result is that these properties will continue to be owned by parties who have insufficient funds to maintain the properties and therefore significant deterioration of the facilities often results.

The Bill makes significant strides in meeting the goal of preserving low-income housing by excluding from taxable income a portion of the gain realized by a seller of low-income property from taxable income if the property will be maintained as low-income property by the purchaser. This provides a real incentive for sellers who are unable to maintain the property to sell and to seek buyers who are committed to providing housing for the poor.

Under the Bill, the "qualified low-income housing project" can be sold after a five-year holding period. For a project to be eligible for the low-income credit, however, there must be a ten-year period between placements in service. While the Bill provides an incentive for sellers, there would be no incentive for buyers to purchase the building unless they had the potential of receiving the low-income credit. That potential can be there only if the low-income credit rules are amended to provide that projects purchased from sellers who receive the benefit of new Code section 135 are eligible for the low-income credit without regard to the 10-year holding period rule.

A "Qualified Disposition" requires among others, that a partnership contribute the capital required to repair and restore the project to a sound physical and financial condition. While it is clear that the partnership should be required to contribute capital, the language of this section implies that assistance from other sources is not permitted and therefore should be amended to reflect that a project acquired by a partnership can receive, for example, local grant funds without violating Code section 135.

ALTERNATIVE MINIMUM TAX

A further incentive to the preservation of low-income housing would be to permit investors in these projects to reduce their alternative minimum tax by the passive losses generated by the project.

1905k

Park Forest Cooperatives

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Park Forest, Illinois 60466
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February 26, 1988

Mr. Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

REFERENCE: H.R. 3663; SEC V and VI

Dear Mr. Leonard:

On behalf of 390 cooperative shareholders of Park Forest Cooperative III in Park Forest, Illinois; please make a matter of record this statement for review by the honorable Charles B. Rangel, Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives.

Please consider this a statement of support for broadening the scope of SEC V and VI of H.R. 3663 to coincide with current proposals by the National Cooperative Business Association, National Association of Housing Cooperatives, New York Council of Cooperatives, Federation of New York Cooperatives, the Coordinating Council of Cooperatives and the Mitchell-Lama Council.

Specifically:

1. treatment of interest on mandatory (required by the terms of the mortgage) and reasonable reserves and escrows for all housing cooperatives as member income;
2. clarification that insurance proceeds from residential property which will be reinvested or placed in a reserve for the property's repair or improvement are member income;
3. treatment of commercial income as member income for low and moderate income cooperatives;
4. repeal of the 80/20 test and replacement with a principal purpose test for all housing cooperatives;
5. inclusion of a no judicial reference clause, as it relates to the applicability of Section 277.

Thank you for your attention to this very important matter.

Sincerely,

H Jack Lemon

H. Jack Lemon
President/Board Chair

HJL:bjt

The Real Estate Board of New York, Inc.

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TEL. (212) 532-3100
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Steven Spinola
President

March 17, 1988

Robert J. Leonard, Esq.
Chief Counsel, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Subcommittee On Select Revenue Measures
Hearings March 2 & 3, 1988

Dear Sir:

The Real Estate Board of New York, Inc., whose 5600 members include owners of government-subsidized low and moderate-income rental housing projects that are or shortly will be eligible to "opt out" of their respective governmentally-restricted programs, supports the concept of HR 3663, sponsored by Chairman Rangel and Representative Frank, which would provide additional tax incentives to encourage the voluntary preservation of existing government assisted rental housing.

It is critically important to provide new financial incentives to persuade the present owners of such housing to forgo their right to convert such properties to more profitable uses given the almost total lack of new low and moderate-income housing development. At the same time, we firmly believe that any such measures must be voluntary and must not impair the owners' contractual right to prepay their government-subsidized mortgages and rent or sell their properties free from regulation under the government-subsidy program.

As we understand it, HR 3663 would provide the following tax benefits to owners of existing government-subsidized rental housing projects, which would otherwise be eligible to free their projects from program restrictions on rents or income, provided that such owners agreed to (i) continue operating the projects under the restrictions of the government-subsidy program for an additional period equal to the greater of twenty years or the remaining term of any government-subsidized debt on the property, and (ii) make capital contributions in an amount the appropriate government official determines to be necessary to restore the property to sound physical and financial condition.

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Newmark & Company, Inc.
Gerald D. Keller
Olympia & York
Samuel H. Lindenbaum
Rosenman Colin Freund Lewis & Cohen
Leonard Litwin
Glenwood Management Inc.
Alton G. Marshall
The Lincoln Savings Bank
Bernard H. Mendik
Mendik Company
Howard P. Milstein
Milstein Properties
James J. Murray
The Chase Manhattan Bank, N.A.
Claude R. Nash
Rockefeller Group, Inc.
Carol D. Nichols
Teachers Insurance and Annuity Assoc.
Joseph E. O'Gara
Huberth & Peters, Inc.
Burton P. Resnick
Jack Resnick & Sons, Inc.
Edward A. Riguardi
Williams Real Estate Co., Inc.
Howard P. Ronson
HRO International
Frederick P. Rose
Rose Associates
William C. Rudin
Rudin Management Co., Inc.
Harvey Schulweis
Lazard Realty, Inc.
Larry A. Silverstein
Silverstein Properties, Inc.
Richard Speciale
Morgan Guaranty Trust Co.
Jerry I. Speyer
Tishman Speyer Properties
William H. Stern
Sonnenblick-Goldman Corp.
Conrad D. Stephenson
The First National Bank of Chicago
Charles J. Urstadt
Pearce, Urstadt, Mayer & Greer
John Robert White
Landauer Associates, Inc.
Fred Wilpon
Sterling Equities, Inc.
William Zeckendorf
Zeckendorf Company, Inc.
John E. Zuccotti
Brown & Wood

1. The adjusted basis of the property would be increased to the original acquisition cost plus the amount of any expenditures for capital improvements incurred before the agreement date. This "stepped up" basis would determine the future depreciation deductions allowable to the owner as well as the amount of taxable gain on ultimate disposition of the property.

2. Assuming that 10 years have passed since the property was placed in service (or substantially rehabilitated) and the project, or a portion thereof, otherwise qualifies for the low-income housing tax credit, the owner would be treated as placing the property in service on the agreement date. The amount of the tax credit would be based on the stepped up basis described above.

3. The 10-year "anti-churning" requirement of the low-income housing tax credit would also be waived if (1) the appropriate government official determined that the availability of the credit was necessary to avoid default or enable the project to be retained for low-income use, or (2) the owner had acquired the property from a governmental body after a default.

Alternatively, non-corporate owners of existing low and moderate-income projects would be encouraged to sell their projects to (a) a non-profit tenants' organization or other non-profit entity whose exempt purpose includes the fostering of low-income housing, (b) a state or local government unit, or (c) a partnership that contributes enough capital to restore the project to sound condition. In the event of such a "qualified disposition," the seller or sellers of such property would be allowed to exclude from gross income an amount equal to the excess of the indebtedness on the property over its adjusted basis (without regard to the "step-up" referred to in 1. above). Thus, if such a disposition can be structured, such non-corporate taxpayers could avoid being taxed on the "phantom gain" that occurs when a property has indebtedness in excess of adjusted basis.

While we applaud the concept of HR 3663 as a first step toward the enactment of the kind of voluntary incentive program that is necessary to encourage owners to continue to operate low and moderate-income rental housing projects under the restrictions of existing programs, we believe that it will achieve its objective only if some important additions are made to the language of the bill. These amendments are outlined below:

I. Exemption From Passive Loss Rules

Because the stepped up basis provided under HR 3663 will produce "passive losses" which are usable only against "passive activity income" for most non-corporate taxpayers, the benefits provided by the bill will have limited utility to individual and partnership owners of existing low and moderate-income projects.

The present limited exception to the passive loss limitations of the Internal Revenue Code, permitting individual taxpayers with adjusted gross incomes of less than $250,000 to use up to $7,000 of the low-income housing tax credit annually to offset non-passive income, has not achieved its purpose and certainly will not constitute a realizable benefit to many, if not most, owners of existing low and moderate-income projects. Thus, in order to make the proffered incentive real, the depreciation deductions generated by the stepped up basis provided by the bill must be exempted from the passive loss rules.

II. Housing Tax Credit Allocation

Without an increase in credit authority to the states, or an exemption from credit authority limitations, use of the low-income housing tax credit to encourage preservation of existing low-income housing could have the unintended effect of substituting preservation of the existing low-income housing stock for the addition of new low-income units to the stock when both are needed. Either an increase in funding for the credit sufficient to cover the anticipated preservation need or an exemption from the credit authority limitations for such preservation projects is needed.

III. Technical Corrections

In order to make the low-income tax credit a viable incentive for either the preservation of existing low-income housing or the production of new low-income housing it is imperative that the Congress promptly enact both the technical and substantive modifications to that credit embodied in HR 3545 as passed by the House of Representatives in 1987, but not included in the bill as finally enacted. These critically-needed modifications would remove a significant impediment to the use of the credit

If HR 3663 is amended to incorporate the above changes we believe that the owners of a significant number of government-subsidized rental housing projects in New York City and New York State (including a large number of State and City-assisted "Mitchell Lama" projects) will continue to operate their projects under the rent and income restrictions now applicable, or to sell to partnership which will agree to do so, in return for the substantial tax incentives that would be provided by the bill as so amended.

Sincerely yours,

Steven Spinola

cc: Hon. Charles Rangel
Hon. Raymond McGrath

STATEMENT OF TIBERIO SCHWARTZ, ESQ. A MEMBER OF PHILLIPS, NIZER, BENJAMIN, KRIM & BALLON ON BEHALF OF RIVERBAY CORPORATION BRONX, NEW YORK (CO-OP CITY) BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES REGARDING H.R.3663

March 16, 1988

Mr. Chairman and Members of the Subcommittee:

I am writing to present our views regarding Section 6 of H.R.3663 (classification of certain income as membership income for purposes of Section 277.)

We appreciate that your committe has been sensitive to the needs of housing cooperatives especially those formed to provide housing for lower and middle income families. In keeping with this view Section 6 of H.R.3663 was inserted in the bill to provide relief from the provisions of Section 277 for limited equity housing cooperatives (LEHC). However, many housing cooperatives, which are truly limited equity cooperatives such as Co-op City would not be treated as LEHC's under the definition of an LEHC in the present bill. In addition, even after the definition of LEHC's is modified to include housing cooperatives like Co-op City, Co-op City could still have substantially adverse financial problems under the IRS' interpretation of Section 277 and the present bill does not address such problems.

I recognize you are quite familiar with the background of the controversy surrounding the attempted application of Section 277 to Cooperative Housing Corporations and so will not burden you with further repetition of the salient issues. Rather, I would prefer to provide you with some background on Co-op City, and the manner in which the IRS has attempted to apply Section 277 to Co-op City, and to offer for your consideration some suggested changes to H.R.3663 to alleviate Co-op City's problems.

I. HISTORY OF CO-OP CITY

Co-op City is the world's largest housing cooperative, providing housing for over 15,000 families.

Co-op City was developed in the mid-1960s by the United Housing Foundation, a federation of housing cooperatives, civic groups, labor unions and other non-profit organizations. Responding to the shortage of moderate-cost housing in the New York area, Riverbay was organized as a "limited profit" housing company under the Private Housing Finance Law of the State of New York (Mitchell Lama Law) for the purpose of owning, maintaining and operating the low and middle income cooperative housing development known as Co-op City. Construction of Co-op City commenced in 1966 and was completed by 1972.

The Co-op City community reflects a diversity of religious and cultural backgrounds. Since Co-op City was developed for persons of low and moderate income, applicants with income above pre-set limits are ineligible for a Co-op City apartment. In addition to the large proportion of office and blue collar workers, over one-third of the families are comprised of senior citizens.

The cost of constructing Co-op City was significantly greater than originally estimated. This factor, coupled with various factors including efforts to maintain carrying charges at a level which was in keeping with the income levels of the tenants, resulted in a weakened financial condition. Ultimately, Co-op City found it difficult to meet its mortgage obligations.

II. Nature of the Section 277 Problems

The Section 277 problems affecting Co-op City have basically related to income which arose from two sources: 1) Interest income and 2) Income from insurance proceeds.

INTEREST INCOME

Reflecting the State's interest in maintaining affordable housing, and its responsibility for a number of defects in the original design and construction of Co-op City, and in order to effectuate a long term solution to Co-op City's substantial financial problems, the State, through the NYS Housing Finance Agency, entered into a number of mortgage workout agreements with Riverbay, one following a rent strike in 1976, one in 1980 and the most recent one in 1986. Pursuant to these agreements, various accounts were set up to help Co-op City with a Construction Defect Repair Program and to fund its mortgage obligations.

In addition, in order to try to prevent the kind of financial problems that previously had plagued Co-op City, the management instituted a program of setting up additional reserves in various accounts to make sure that it would have the funds to pay its mortgage and other expenses. These accounts, set up by Co-op City as an integral part of providing housing to its tenants, generated interest income which was treated by Co-op City as membership income.

INSURANCE PROCEEDS

In 1980, an explosion destroyed one of the four boilers in Co-op City's power plant. While a portion of the insurance proceeds were used to repair the damage to adjacent areas, most of the proceeds were put in escrow pending a final engineering decision on the boiler replacement (including consideration of an energy-saving cogeneration system). Also, following the boiler explosion, the New York City Environmental Protection Agency directed Co-op City to switch to burning only fuel oil. This resulted in substantially increased fuel costs for Co-op City (through 1985, the aggregate cost difference exceeded six million dollars).

In accordance with established tax law, Riverbay reported a "gain" for tax purposes from the insurance funds not yet reinvested. The extra fuel expenses were also properly deducted, along with other operating expenses, and thus no tax was actually due. Now the IRS believes that the gain should be carved out and separately taxed as non-membership income.

IRS POSITION

The IRS has taken the position that both the interest income from the reserves and a portion of the insurance proceeds should be treated as non-membership income. Accordingly, the IRS has proposed adjustments in Co-op City's income taxes which would require Co-op City to pay in excess of $3,500,000 in income taxes for the period 1981-1985. If Co-op City were required to make such payment (plus interest which would substantially increase such amount), it would seriously undermine the housing complex's financial stability at a time when it has finally started to resolve its previous financial difficulties.

III. Recommendations

You introduced Section 6 of H.R.3663 in order to help cooperative housing corporations which qualified as LEHC with a portion of their Section 277 problem. The intent of the bill seems to be to include within the definition of an LEHC a housing cooperative formed under programs designed to create housing for low and middle income families.

Mitchell Lama is just such a program. However, due to various technical definitions, certain cooperatives, including Co-op City, which were formed under the Mitchell Lama Program, would not qualify as a LEHC under H.R. 3663. This is true even though Co-op City is a limited equity cooperative (its shareholders cannot profit upon the resale of their shares in the cooperative). We understand that there may be other Mitchell Lama housing cooperatives in New York City which would also not qualify as LEHC's under the present definitions set forth in H.R. 3663. Accordingly, we would suggest that the definition of an LEHC under H.R.3663 be expanded to include housing cooperatives, such as Co-op City, which were created to provide housing for low and middle income individuals.

In addition, we feel that the provisions of H.R.3663 should be expanded to provide that interest income, whether from mandatory reserves or from prudent reserves which are integrally intertwined with the cooperatives function of providing housing, should be characterized as membership income.

Moreover, the bill should clarify the character of income arising from the receipt of insurance proceeds received on account of the destruction of assets integrally related to providing housing by the housing cooperative, e.g. insurance proceeds received on account of the destruction of a boiler used to provide the cooperators with heat. To the extent that such insurance proceeds are to be included in income pursuant to other provisions of the Code, such income should be classified as membership income. There are two reasons for our suggestion. First, the gain realized upon the receipt of such insurance proceeds would be determined based on the tax basis of the asset that was destroyed. Such asset's tax basis would have previously been reduced on account of depreciation deductions which would have been treated in the year the depreciation was taken as a membership expense. Thus, it would be unconscionable to characterize such insurance proceeds as non-membership income since a portion of this income, only, would be generated because of the reduction in tax basis caused by depreciation deductions. These deductions, when taken, were characterized as membership deductions. In addition, characterization of such income as membership income would bring into line the definition of membership income for purposes of Section 277 with the definition for purposes of Subchapter-T. Thus, for example cases under Subchapter-T have held that gain from the disposition of assets integrally related to a cooperative's normal activities are to be considered patronage (membership) income. See e.g. St. Louis Bank for Cooperatives v. United States 80-2 USTC. ¶9509; Astoria Plywood v. United States 1979-1 USTC ¶9197.

In addition we would recommend that H. R. 3663 be clarified to insure that funds received from any governmental authorities are not treated as non-membership income. It would appear to be incongruous for a housing cooperative such as Co-op City to receive funds from the State to insure that it is able to continue providing housing to lower and middle income individuals, such as the housing needs of 15,000 families of Co-op City, and to then have the Federal Government, through the IRS jeopardize its very financial stability by treating such government funds as non-membership income.

By participating in the Mitchell Lama program and similar types of programs, cooperatives such as Co-op City receive certain benefits such as property tax abatements and reduced interest rates on mortgages and they are not required to classify such benefits as non-membership income. We believe that all other government grants or payments should be treated in the same fashion and that there should not be a difference whether the benefits are received through reduced interest rates or by outright grant of funds. In either fashion, the concept is to help provide decent housing for lower and middle income families and therefore there is no rational basis for distinguishing between the various kinds of government assistance programs. Moreover, we believe that such government-provided funds are as integrally intertwined with the operation and goals of the housing cooperative as the maintenance charges paid directly by the cooperators. We believe that these funds are analogous to funds received through goverment assistance such as Section 8 payments which are treated as membership income.

Thank you for your consideration in this matter.

Riverside Braemar, Inc.
Community of Cooperative Apartment Homes
4679 Braemar Place
Riverside, California 92501
Telephone (714) 684-0380

March 14, 1988

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Sir:

We strongly believe that it would be in the best interests of all Cooperative Housing projects if Bill HR3663 were broadened to:

(1.) treat interest on mandatory(required by terms of the mortgage) and reasonable reserve and escrows for all cooperatives as member-related income;

(2.) clarify that insurance proceeds from residential property which will be reinvested or placed in a reserve for the property's repair or improvement is member-related income;

(3.) confirm that government subsidies and grants(like Section 8) are not non-member income;

(4.) treat commercial income as member related income for low and moderate income cooperatives;

(5.) repeal the 80/20 test and replace it with a principal purpose test.

(6.) make no reference to the applicability of Section 277 to housing cooperatives, or betteryet, state that 277 does not apply to (housing) cooperatives.

For the Riverside Braemar, Inc
Board of Directors

Sincerely,

John D. Plant

John D. Plant
Resident Manager

cc/Auditor file
HUD
NAHC

RURAL COMMUNITY ASSISTANCE CORPORATION
2125 19th Street, Suite #203
Sacramento, CA 95818
(916) 447-2854

March 16, 1988

The Honorable Charles B. Rangel, Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means
1102 Longworth House Office Building
U.S. House of Representatives
Washington, D.C. 20515

RE: Tax Deductions for Housing Cooperative Members

Dear Chairman Rangel and Members of the Committee:

RCAC is a nonprofit housing and community development corporation that assists community groups, nonprofit agencies and local governments throughout the western United States to meet their local needs. One area in which we have been active is establishing housing cooperatives both through new construction and the conversion of existing housing developments.

At this time, we are focusing much of our attention on the plight of mobile-home park residents, many of whom are elderly. Park residents own their own homes and pay rent for their spaces. Increasing land values throughout much of the West have led to tremendous rent increases and many parks have closed to make way for more profitable uses such as shopping centers and office complexes. RCAC works to preserve affordable housing by helping park residents purchase their mobile-home parks as cooperatives.

As you know, the members of housing cooperatives may deduct a proportion of the mortgage interest and property taxes paid by the cooperative on their individual income tax returns. By allowing individuals to take these deductions, cooperative ownership is treated the same as ownership of a home or condominium where the homeowner pays the mortgage interest and property taxes directly.

In order to pass deductions on to individual members, however, cooperatives must own or lease complete housing units that are occupied by the members. In mobile-home park cooperatives, the members own their individual homes and the co-ops own only the sites, roads and common facilities. Consequently, the members of these co-ops cannot deduct their share of the interest and taxes paid by the cooperatives. (Please see enclosed ruling.)

There can be no logical reason why Congress would want to treat the members of these cooperatives differently from other housing co-op members. In fact, there are many reasons why lower cost housing options like mobile-home parks should be encouraged by the federal tax codes. The most likely reason why the members of these co-ops are denied tax deductions is that no one ever imagined that there would be mobile-home park housing cooperatives when the Internal Revenue Codes were originally written.

This inequity can be corrected very easily by simply amending Section 216(b)(1)(B) to specifically include mobile-home park in the definition of cooperative housing corporations. We request that you include this change in any legislation which is developed as a result of your hearing.

Thank you for this opportunity to present this information and our concerns.

Sincerely,

Will French

William French
Executive Director

MS:housing#4:mohojr.doc:JR:WF:jpMarch 16, 1988 cause large decreases in the market value of the previously issued bonds that are to be refunded, and where these decreases are so great that, if the holders of the previously issued bonds were to accept tender offers for their bonds, then the acceptances would cause the proceeds of the refunding bonds to exceed the amount needed for refunding the previous issue, such a tender offer will not cause the refunding bonds to be arbitrage bonds under section 103(c) of the Code.

Section 216.—Deduction of Taxes, Interest, and Business Depreciation by Cooperative Housing Corporation Tenant-Stockholder

26 CFR 1.216-1: Amounts representing taxes and interest paid to cooperative housing corporation.

Cooperative housing corporation; housetrailers. The requirements of section 216(b)(10(B) of the Code are satisfied if housetrailers and the land on which they are permanently located are owned by a cooperative housing corporation, the tenant-stockholders are entitled to occupy for dwelling purposes the housetrailers by reason of stock ownership, and the housetrailers contain independent living facilities for one family including permanent provisions for sleeping, eating, cooking, and sanitation.

Rev. Rul. 85-147

FACTS

Situation 1

X corporation purchased a trailer park, consisting of 20 housetrailers and the land on which the housetrailers were permanently located. *X* corporation sold shares of stock to individuals each of whom, by virture of ownership thereof, was entitled to occupy one of the housetrailers owned by *X* corporation and the land on which the housetrailer is located. Each of the housetrailers contains independent living facilities for one family including permanent provisions for sleeping, eating, cooking, and sanitation.

Situation 2

The facts are the same as in *Situation 1*, except that *X* corporation does not own the 20 housetrailers, but only the land on which the housetrailers are located. The housetrailers are individually owned by stockholders of *X* corporation. Each stockholder is entitled, by reason of stock ownership, to occupy only the land on which the stockholder's housetrailer is located.

LAW AND ANALYSIS

Section 216(b)(1)(B) of the Code defines a cooperative housing corporation, in part, to mean a corporation each of the stockholders of which is entitled, solely by reason of the stockholder's ownership of stock in such corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation.

For purposes of section 216(b)(1)(B) of the Code, the term house means a residential unit providing complete, independent living facilities for one family including permanent provisions for sleeping, eating, cooking and sanitation. *See* Rev. Rul. 74-241, 1974-1 C.B. 68, which similarly defines the term apartment for purposes of section 216(b)(1)(B).

Section 1.216-1(d)(2) of the Income Tax Regulations provides that in order for a corporation to qualify as a "cooperative housing corporation," each stockholder of the corporation, whether or not the stockholder qualifies as a tenant-stockholder under section 216(b)(2) of the Code and section 1.216-1(e) of the regulations, must be entitled, to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation.

Since the housetrailers have sleeping, eating, cooking, and sanitation facilities in *Situations 1 and 2*, each housetrailer constitutes a house within the meaning of section 216(b)(1)(B) of the Code. Further, the requirements of section 216(b)(1)(B) are satisfied in *Situation 1* because the housetrailers are owned by *X* corporation and each stockholder of *X* corporation is entitled, solely by reason of the stockholder's ownership of stock in *X* corporation, to occupy one of the housetrailers owned by *X* corporation. However, the requirements of section 216(b)(1)(B) are not satisfied in *Situation 2* because *X* corporation does not own the housetrailers that its stockholders occupy. Instead, each stockholder in *Situation 2* is entitled to occupy the housetrailer owned by the stockholder by reason of such ownership and not by reason of the stockholder's ownership of the stock of *X* corporation.

HOLDING

Although each housetrailer in *Situations 1 and 2* constitutes a house within the meaning of section 216(b)(1)(B) of the Code, the requirements of section 216(b)(1)(B) are satisfied only in *Situation 1*, but not in *Situation 2*.

Section 2001.—Imposition and Rate of Tax [Estate Tax]

T.D. 8044

TITLE 26—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER B, SUBCHAPTER H, PART 27—TEMPORARY ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1984; PART 602—REPORTING AND RECORDKEEPING REQUIREMENTS

Reports of Transfers of Public Housing Bonds

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary estate, gift and generation-skipping transfer tax regulations relating to the reporting requirements for certain transfers of public housing bonds under the Tax Reform Act of 1984 [1984-3 C.B. (Vol. 1) 1]. The regulations provide Internal Revenue Service personnel who administer the Internal Revenue Code and members of the public with the guidance necessary to comply with the law.

DATES: The regulations apply to transfers of public housing bonds made after December 31, 1983, and before June 19, 1984.

FOR FURTHER INFORMATION CONTACT: Fred L. Grun[illegible]man of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) 202-566-3287, not a toll-free call.

San Tomas Estates, Inc.
1335 PHELPS AVE.
SAN JOSE, CALIF. 95117
(408) 241-0685

March 21, 1988

Mr. Robert J. Leonard, Esq.
Chief Counsel, Committee on Ways and Means
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Sir:

We would like to go on record as supporting the testimony of N.A.H.C. president Mr. Terry Lewis delivered to your committee on March 3, 1988, in regards to H.R. 3663

We are a complex of 95 units, financed by F.H.A., in existence since 1963 and we can certainly attest to all the statements Mr. Lewis has made. There have been many occasions during these 25 years when the operating reserve has helped us over rough spots which occured unexpectedly. We try as much as possible to foresee all the necessary projects to be handled during the year when making out our budget, but, as in all corporations, no one can foresee all emergencies.

If the policy for taxing cooperatives is changed, it certainly will cause a hardship on our members.

We would appreciate your support of Mr. Lewis' testimony so that affordable housing does not totally disappear.

Sincerely,

Dwight T. Denno

Dwight T. Denno
President

3-18-88

Dear Congresspersons & Repres:
Senators:

Enclosed is my attitude and feelings of hate toward the Low Income Housing Tax Credit, H.R. 3 (!) Isn't it enough that builders, etc. get to procure government funds for projects? They ought to feel lucky that the funds are available in the first place. Adding a tax credit for low-income - GOVERNMENT SUBSIDIZED housing just adds fuel to the deficit fire, doesn't it? To get more credits the builders, developers + contractors want for more funds and the snowball effect of debt is at work. The young American public is sick of working ourselves to the bones & then see junky bills like this even be "thought-of" Is this the type of act that you call revenue neutral?

Face it, the U.S. Gov't leads in being the worse collector of debt & rents ever. This is especially true in the collection of low-income

Housing loans. Spend, spend, spend & never collect. How about this for an idea... When you collect on loans out there, then that money can ~~then~~ be "re" available for use - Example -

5 million is set up & used for funding loans, so 5 million is gone -

say 1 yr later, 1 million principle is pd back, then that 1 million is available for loaning again -

and 5 million is the ceiling, the limit!
instead of more & more & more

You people in office representing the American workforce have just got to see that we are sick of low-income & welfare type subsidies. Shouldn't the low-income housing builders & contractors be thankful for what they have & quit asking for more? - Gee - that sounds ~~the~~ like something JFK would say.

In summary, I am totally

against continuing the bill. Our representatives in congress need to learn something from Nancy Reagan - namely how to
Just Say No!

Lisa Saunders
316 Old Village Rd
Columbus, Ohio
43228

March 7, 1988

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: HR 3663

Dear Mr. Leonard:

We wish to express our support for requests to amend HR 3663.

We believe that Congress should clarify for the Internal Revenue Service that cooperative housing corporations, as defined in Section 216 of the Internal Revenue Code are not membership organizations as described in Section 277 of the Code. Efforts to apply Section 277 to cooperative housing corporations has minimal significance for government revenues but can have disastrous impact on a relatively limited number of such cooperatives, inhibit implementation of good business judgments in providing for reserves for future rehabilitation of such housing and for contingencies, and frustrates well thought out plans to provide cooperative housing to low and moderate income families through government and othe subsidies, grants and providing for commercial income within a cooperative housing development.

Consequently, HR 3663 should provide that Section 277 of the Internal Revenue Code relating to social membership organization is not applicable to cooperative housing corporations as defined in Section 216 of the Internal Revenue Code and amend Section 216 by adopting a principal purpose test in place of the 80-20 test.

HR 3663 should also define as member or patronage source income or income earned or received to facilitate the principal purpose of the cooperative (a) government subsidies (such as Section 8 housng assistance) and grants; (b) insurance proceeds which are placed in a reserve for repair or improvement of the property; (c) interest on mortgagee, mortgage insurer or governmental agency and other reasonable reserves and escrows related to the required principal purpose of the cooperative housing corporation; and (d) commercial income in cooperatives housing low and moderate income families.

Very truly yours,

Edward G. Adams
Board President
Silent Co-Op Apts.

Edward G. Adams
Board President
SILENT COOPERATIVE APARTMENTS

March 9, 1988

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
Washington, D.C. 20515

Dear Mr. Leonard:

Our main concern is the low-income credit for 1987. We placed a duplex in service August 1987, at that time no information was available as how to apply for these credits. Finally during January of 1988 we finally obtained the necessary forms but were told we were to late to apply for any tax credits.

Because 1987 was the first year of these credits and so little information was available we feel that those who were eligible for 1987 credits should have a grace period to apply for these credits.

The tax credits appear to be a good vehicle to produce low-income housing. We will be responsible for maintenance and income of the housing, thus the disastrous public housing projects across the country will be a thing of the past.

But one year after first hearing about these tax credits we are still digging for information about requirements and applications to apply for these credits.

Next week we plan to attend a seminar for low-income housing. I hope this will finally give us the direction we need. Please consider some way of making the credits available to those projects on line during 1987

Thank you for your consideration in this matter

Larry G. Smith

C. Michael Greeley

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COMMITTEE ON
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WAYS AND MEANS

March 9, 1988

Robert Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Low Income Housing Tax Credit Program

Dear Mr. Leonard:

I have been informed that the House Ways and Means Committee is considering possible changes in the Low Income Housing Tax Credit Program and the possibility of proposing other tax incentives for low-income housing, and that comments are being solicited prior to March 17.

I have been retained by two clients in connection with structuring transactions under the Program and can offer some suggestions as to how it may be improved in order to better effect its purpose.

The Program, when used in connection with new construction or major rehabilitation of housing in an urban area (both of the projects with which I am familiar are located in San Francisco), is not sufficient by itself to make feasible the development of low-income housing. In other words, the gap between the actual cost of a project and the portion of that cost which can be borne by the project's revenues is greater than the amount of capital which can be raised by virtue of the tax credit. Thus, projects need additional subsidy, either from public or private sources. In some cases, this subsidy can be obtained, for example, by the availability of surplus public property or various other sources. In most cases, projects fail because of a lack of such other sources and, as we are seeing, the tax credit program is underutilized.

The Program is currently aimed at the "very low-income" population--that is, those earning less than 60% of area median. In most urban areas, housing for persons in the "low-income" category--those earning between 60% and 80% of area median--is one for which no feasible housing can be constructed and one for which federal assistance has traditionally been available. Some amount of federal tax credit should be available for this group in order that economic segregation not occur in the projects which are developed. Since unsubsidized low-income units cannot be feasibly built, they will be excluded from the projects, resulting in projects which are 100% very low--possibly resulting in the "housing project" syndrome: enclaves of the very poor.

A solution to both the problem of meeting the needs of the low-income population and making the Program feasible could involve a two-tiered system of credits, whereby the 70% credits could be made available for low-income units and a 100% credit could be made available for very-low income units. These percentages could be adjusted, depending on feasibility. The percentages should also be adjusted depending on construction and land costs in urban areas. While it may be feasible to build a project in a remote rural area under the existing scheme, a different scheme would be necessary to make an urban project work.

Finally, on a very technical level, we have run into resistance from the Internal Revenue Service regarding the use of the tax credits in combination with other forms of public assistance. In a project involving a no interest loan from a public agency, we were informed that the Internal Revenue Service was inclined to view the public agency as a "partner" and not a lender and that the amount of the loan would be subtracted from basis. The argument was that the public agency was promoting its own ends--that is, the provision of low-income housing--and that it was an equity participant in the transaction. This is contrary to the practice followed for many years under Section 167k depreciation allowances, whereby many projects were built with a combination of no- or low-interest loans and tax advantage. We get the impression that the tax credit program is disfavored by the Internal Revenue Service for revenue reasons.

I hope that the foregoing has been of assistance to you. We would be happy to provide you with concrete examples regarding the foregoing points if you so desire.

Very truly yours,

SL Taber

Stephen L. Taber

SLT:ln
cc: Barbara Smith

TESTIMONY BY CONGRESSMAN TED WEISS IN CONNECTION WITH THE HEARING OF THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE HOUSE COMMITTEE ON WAYS AND MEANS REGARDING H.R. 3663 AND THE ROLE OF FEDERAL TAX POLICY ON LOW AND MIDDLE INCOME HOUSING, MARCH 3, 1988

I wish to take this opportunity to submit my comments to the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in connection with the hearing that was held to consider H.R. 3663 and the role of federal tax policy on low and middle income housing.

I would like to express my appreciation to the Chairman, Congressman Charles Rangel, and to the members of the Subcommittee for holding these hearings and for demonstrating their concern about the housing stock in this country for people of modest means.

I am gravely concerned about the current efforts of the U.S. Internal Revenue Service to apply Section 277 of the IRS code to the low and middle income cooperative housing complexes in my district. This procedure will have serious ramifications not only for buildings in the 17th Congressional District, but also in all such developments in New York, and throughout the nation.

Although Section 277 of the IRS code was enacted by Congress in 1969, it was not until many years later that any attempt was made to connect housing cooperatives with Section 277.

Section 277 provides that non-member income received by membership organizations cannot offset for tax purposes the cost of providing goods and services to organization members. Yet section 277 does not appear intended for housing cooperatives. The code refers to social or other membership organizations such as country clubs, burial societies, or mutual insurance societies "operated to furnish goods or services to members." Section 277 requires that member income and expenses be separated from non-member income and expenses, taxing each separately. However, housing cooperatives are neither social clubs nor "membership organizations" as that term is commonly used and understood.

By suggesting that Section 277 is applicable, the IRS has left open to possible taxation such items as interest on reserve funds, income from commercial properties such as garages or stores, and laundry room proceeds. The IRS claims that this income is not from shareholders and cannot be offset by operating expenses of the building or by depreciation. This would be particularly onerous for mutual redevelopment cooperatives and those subsidized under the New York State Mitchell Lama program which were purposely set up with commercial space to both provide a new location for business displaced by redevelopment and to generate revenue to reduce the amount of subsidy that would be necessary to keep housing affordable to low and moderate income families.

Many legal experts maintain that Section 277 of the IRS code was not intended to and does not apply to cooperative housing developments. Cooperatives in New York City are organized under the New York State Private Housing Finance Law as stock corporations. It owners are "shareholders" not members. Residents do not pay dues, but lease separate residential apartments from the cooperative. Furthermore, housing cooperatives are not primarily engaged in providing goods or services to its members. When congress has intended an Internal Revenue Code provision to encompass the furnishing of real property, it customarily makes explicit reference by using the term "facilities."

Limited Equity Cooperatives in New York are required to maintain a reserve fund in an interest-bearing account under New York State Law. Without these reserves, the development could not participate in Mitchell Lama and other middle income housing programs and its benefits would be lost to shareholders. Certainly, the relationship between interest income and its benefits to shareholders should lead one to conclude that, even if Section 277 were to apply, it is membership income and should not be taxed under Section 277, since it is integrally intertwined with the cooperative's functions.

I strongly urge this committee to take steps to protect low and middle income cooperatives from the onerous taxation that would result from the application of Section 277 so that they may be preserved as providers of affordable housing. I urge you to amend H.R. 3663 to insure that interest on reserves be treated as part of the cooperative enterprise.

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Joel David Welty
5902 South Carter Road
Freeland, Michigan 48623-9309

March 7, 1988

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: HR 3663

Dear Mr. Leonard:

Maintenance of the nation's stock of affordable housing is a desperately important concern. Especially important is to preserve affordable housing that enables people to own their own homes and control their own neighborhoods, for example through limited equity housing cooperatives. That can best be done by strengthening the position of housing cooperatives in relation to income tax law.

Presently, a housing co-op must receive 80% or more of its income from members' carrying charges, or the members lose their right to deduct property taxes and mortgage loan interest on their personal income tax returns. As this requirement works out in actual practice, it is discriminatory against co-op homeowners. If a co-op receives interest on its mandated reserve funds, or insurance proceeds, or a government subsidy or grant, or income from renting out spaces for dry cleaning shops, laundry machines and other needed services for residents -- that income ought to be considered as member-related income. It is an integral part of the effort to create a decent neighborhood in which to live. But presently the law counts that income as not member related and if it adds up to more than 20% of the total, co-op members lose their deductions of property taxes and mortgage loan interest. Co-op homeowners should not be deprived of the rights granted to all other homeowners. The 80/20 test does not make sense. The only sensible test is to consider the principal purpose of the co-op's buildings -- to provide homes to people as economically as possible, making every penny count toward that purpose. We ask that the Ways and Means Committee recommend the replacement of the 80/20 test with a principal purpose test, for the purpose of determining the eligibility of the members to deduct property taxes and mortgage interest.

Many thanks for your consideration.

Sincerely,

Joel David Welty

Wilshire
Regent

March 15, 1988

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
1102 Longworth
House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

The Wilshire Ardmore Cooperative, Inc. dba Wilshire Regent, fully supports the statements of the National Association of Housing Cooperatives before the Subcommittee on Select Revenue Measures on HR 3663. The provision for mandatory replacement and operating reserves and their tax treatment in the past have been a major factor in the successful operation of our 208 apartment cooperative. These resources have enabled us to maintain our building including the appliances of the individual apartments at a high level so necessary for the welfare of our generally older, retired, heavily female occupancy. Since 1972 we have refurbished the interior and exterior of the building, replaced the cooling and heating plants, installed new fire control equipment and updated our elevators to earthquake standards. During this time the monthly carrying charges have been increased only 10 percent, about 1% per year average. There have been no assessments.

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One of the major reasons for our effectiveness is the availability of earning reserves which materially aid in our operations and enable us to avoid changes in charges to the largely fixed income shareholders. The imposition of a direct tax on reserves would seriously deplete the rationality of the reserves and the flexibility of management.

The support of the Subcommittee for the recommendations of the National Association of Housing Cooperatives is strongly urged in the best interests of those who require affordable housing and are willing to work cooperatively toward the goal.

Respectfully,

Allen J. Starling

Allen Starling
President
Wilshire Regent

STATEMENT OF JOHN V. HELMICK ON BEHALF OF THE YALE LAW SCHOOL'S WORKSHOP ON SHELTER FOR THE HOMELESS AND H.O.M.E., INC. OF NEW HAVEN, CONNECTICUT, MARCH 2, 1988*

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE: My name is John Helmick. I am currently a student at the Yale Law School and am a participant in the Workshop on Shelter for the Homeless ("The Yale Shelter Project"). Recently the work of the Yale Shelter Project has concentrated on the formation and representation of H.O.M.E., Inc.

I. H.O.M.E., Inc.

Housing Operations Management Enterprises, Incorporated ("H.O.M.E.") is a non-profit organization incorporated in September, 1987 to provide, protect and manage quality housing for low-income tenants in New Haven, Connecticut. The organization is an innovative community effort designed to address the New Haven region's dire need for affordable housing. As in so many other regions of the country, New Haven's recent economic success has exacerbated an already critical problem of inadequate housing for low and moderate income individuals and families.

H.O.M.E. emerged from two significant movements: (1) the development of the Shelter Project at the Yale Law School and (2) the community and city interest in replacing 55 single room occupancy units lost due to development in downtown New Haven and in providing more and better managed housing for low and moderate-income families, many of whom have had to reside in motels on a "transitional" basis. One of H.O.M.E' s most significant features is the breadth of the individuals and organizations who helped create it.[1]

The Yale Shelter Project began as an informal group of students and faculty at the Yale Law School who came together to create and preserve transitional and permanent housing for homeless and other low and moderate-income people. Many of the students had been active in the Homelessness Clinic, a Yale Law School class which provides free legal services to homeless individuals and families in New Haven area shelters, soup kitchens, and welfare motels. Other students worked for the Landlord-Tenant Clinic, a clinical program representing tenants in eviction proceedings.

While both clinics were successful in lawyering on behalf of the homeless and low-income tenants through the traditional adversarial process, it became apparent that the problems of homelessness required a solution that the court system was not equipped to provide. Long-term solutions required an emphasis on the planning and development of expertise on issues of non-profit corporate law, tax-exempt organizations, and low-income housing. New property management techniques that replaced the traditional adversarial nature of the landlord-tenant relationship were also considered necessary, including such things as grievance procedures, tenant selection, and community relations.

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* This testimony was prepared with the substantial aid of Janet Stearns' article "The Low-Income Housing Tax Credit: A Poor Solution to the Housing Crisis" forthcoming in Vol. 6 of The Yale Law and Policy Review.

[1] Included in this work were the City of New Haven; Karen Crosby of Congressman Bruce Morrison's office; Alderman Joel Ratner; Rev. Karl Hilgert and Liz Shaw of Christian Community Action; Jon Alander and Amy Eppler of New Haven Legal Assistance Association; Cynthia DeLouise of Columbus House; Professors Michael Graetz, Robert Solomon and J.L. Pottenger, Jr. from the Yale Law School and students from both the Yale Law School and the Yale School of Organization and Management.

While the Shelter Project was forming at the Yale Law School, a coalition of New Haven shelter providers, city and federal government officials, and advocates for the homeless banded together to address the rapidly increasing problem of homelessness in the New Haven area. The site of the National Hotel had been condemned and closed as part of a large downtown development. This coalition received a commitment from the City to locate and develop from 35 to 50 scattered units in the downtown area to replace the 55 "single room occupancy" units that were lost when the National Hotel was condemned. The community and government participants met with members of the Shelter Project and conceived the idea of H.O.M.E.. A board of directors was selected, H.O.M.E. was incorporated and became the Shelter Project's first client.

H.O.M.E. was established to address several different needs related to affordable housing. These include: management of low-income properties; training for managers of low-income housing; preservation of low-income housing stock; and creation of housing for low and moderate-income people. Despite the scope of its ambitions, H.O.M.E. is still a small local non-profit committed to providing better housing for the New Haven community.

In late 1987, the organizers of H.O.M.E. negotiated a purchase option agreement on 137 housing units in 27 buildings located throughout the central New Haven area. The buildings involved were in various stages of complete renovation, including new roofs, exteriors, electrical and mechanical systems, sheetrocking and painting. Most had been completed in 1986, but 46 were "placed in service" in 1987 and therefore qualified under Section 42 for the low-income housing tax credit. In December, 1987 H.O.M.E. applied for and received a tax credit allocation for those units from the Connecticut Housing and Finance Authority ("CHFA") in the amount of $1.4 million.

H.O.M.E. has been planning to use the tax credit allocation as the major source of equity financing for the purchase of these housing units. As a non-profit corporation, however, H.O.M.E. may not use the tax credit itself. H.O.M.E. has approached various corporations, institutions, investment bankers, and other potential investors in an effort to obtain the best price in exchange for the tax credit, but has found that EACH DOLLAR OF TAX CREDIT WILL PROVIDE ONLY 35 TO 55 CENTS TOWARDS THE PURCHASE OF LOW-INCOME HOUSING STOCK.

This cost-benefit inefficiency of the Low-Income Housing Tax Credit ("LIHTC") is a common occurrence when Congress relies on tax subsidies to promote a desired federal objective. A 1977 Congressional Budget Office Report concluded:

> Only about half of what the tax shelter subsidy costs the government in lost revenue, however, ever reaches builders and developers. The remainder goes in the

> form of payments to outside investors for the use of their money, and in fees to the syndicators, lawyers, and accountants who are needed to put together and sell the tax shelter package.[2]

The report calculated that 44.5% of the total real estate tax shelter subsidy went to builders and developers, 7.4% to syndicators, and 48.1% to outside investors.

In response to a question on programs for the homeless, President Reagan, in his February 24, 1988 press conference, also called attention to the general inefficiency of government. The President stated

> . . . as a governor I had seen Federal programs administered in our state in which it was costing the Federal Government $2 for every dollar that reached a needy person. This is something we've been trying to change, and we've made some progress in it.[3]

Unfortunately, the low-income housing credit does not seem likely to prove an example of that progress. There may well be important reasons for funding certain programs through tax expenditures rather than direct outlays: Tax expenditures can be less expensive and easier to administer than direct subsidies and they more readily fit our American notions of free enterprise and individual initiative. For a non-profit organization like H.O.M.E., however, the Low-Income Housing Tax Credit represents the worst of both tax expenditure and direct outlay programs: it combines the extensive bureaucracy of a direct outlay with the inefficient complexities of tax expenditures.

OUR PROPOSAL TO THIS COMMITTEE WOULD CREATE A MORE EFFICIENT TAX CREDIT WITH NO ADDITIONAL REVENUE COST TO THE FEDERAL GOVERNMENT

II. Utilization of the LIHTC by non-profits

In enacting the LIHTC Congress clearly wanted to encourage participation by non-profit organizations: Section 42(h)(5) requires each State to set aside 10% of its housing credit dollar allotment for use only by non-profit organizations. The remainder of Section 42 combined with other requirements of the tax code and tax regulations, however, creates a cumbersome tax maze that frustrates a non-profit corporation's ability to use even the 10% minimum set aside -- especially for a small non-profit.

Like many direct federal grant programs, the tax credit creates an administrative bureaucracy by requiring State housing agencies to allocate each State's total amount of credits. This, taken alone, is not an insurmountable obstacle. Like most non-profits, H.O.M.E. was able to mobilize its work force of unpaid volunteers to process the voluminous tax credit applications to the Connecticut State Housing Finance Authority. However, although the State bureaucracy may be a significant obstacle (and thus acts as a check on potential abuse of the LIHTC), it is not our only hurdle. Once the tax credit has been allocated to it, H.O.M.E. must then convert its tax credit allocation into actual dollars that can be used to purchase or rehabilitate low-income housing units. Unlike a direct grant, where H.O.M.E.'s next step would be to pick up the check, the low-income housing tax credit requires H.O.M.E. to contend with the complexities of the tax code if any of these dollars are to go into its housing program.

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[2] Cong. Budget Off., Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives xiv (May 1977).

[3] N. Y. Times, Feb. 25, 1988, at A16, col. 6.

As a non-profit, H.O.M.E. has no taxable income and thus under the current tax laws cannot directly utilize these tax credits. Instead, H.O.M.E. must (1) find investors who can utilize the tax credits allocated to H.O.M.E., (2) package and market -- at a substantial discount -- these tax benefits, and (3) transfer the tax benefits to the investors.

Congress has structured the LIHTC such that the transfer of the tax benefits is accomplished through ownership transfers. Although these ownership transfers are often essentially legal fictions, the necessity of creating and maintaining these legal fictions increases the costs of transfer. Transactions have to be structured so that the distribution of attributes of ownership among the various parties meets state property law, federal tax law and the lender's requirements. Additionally, the minimum 15-year compliance period of the tax credit means that payment and legal title requirements must be constantly monitored to all parties' (investors, syndicators, lenders, and government) satisfaction.

The most common method for accomplishing these transfers would be for a non-profit such as H.O.M.E. to form a for-profit subsidiary which could act as a co-general partner with a real estate syndicator and market the tax credit to individual and corporate investors. (However, it is not clear whether this would threaten H.O.M.E.'s tax-exempt status, which is antagonistic to profit motivated deals such as syndications). H.O.M.E. would then transfer legal ownership of the low-income housing units to this partnership. The reason behind this layering of legal entities would be solely for the purpose of cashing out the tax benefits -- primarily the LIHTC -- that follow the legal title to these properties.

Syndications are the predominant financing arrangement for real estate as they allow investors to pool resources to fund development. Typically, the investors will be limited partners in a syndicate, thereby insulating themselves from risk yet securing maximum tax benefits. The general partner, in this case H.O.M.E. (or a subsidiary of it), would still be responsible for developing and managing the project.

Syndications are both cumbersome and costly. While a private placement is possible on smaller projects, if a public offering is required the partnership must comply with federal securities laws. No matter how small the project, significant financial and legal expertise is required to maximize the tax benefits to investors within the limits established by the Congress and the I.R.S.. The costs of obtaining the necessary lawyers, accountants and investment bankers to put the deal together rapidly eats up the benefits of the tax credit. Additionally, promoters of a public offering earn at least 10% of the proceeds of the offering in commissions and organizational fees. One can only speculate about how many of the dollars Congress intended to go to low-income housing actually purchase entertainment of investment bankers. Thus, the LIHTC is partially diverted away from low-income housing instead to finance expense account dinners and to pay tax lawyers and accountants. Every dollar of the tax credit that goes to the Jockey Club restaurant here in Washington or the Tour d'Or in New York is a dollar that might have enabled residents of New Haven to obtain affordable housing.

III. A Zero Revenue Cost Solution

NON-PROFIT ORGANIZATIONS SHOULD BE ALLOWED A TAX REFUND OF THE AMOUNT BY WHICH THE STATE ALLOCATED TAX CREDIT EXCEEDS THE ENTITY'S TAX LIABILITY.

This innovation would remedy the inefficiency of transferring tax benefits through syndicates of investors by allowing the non-profit organization to receive the full amount of the LIHTC, even if the non-profit has insufficient or no tax liability. Because the remainder of the LIHTC provisions would remain in place, the government's interest in limiting and maintaining judicious placement of this tax expenditure would continue to be guaranteed by the per capita state allocations and state housing authority mandated approval of projects. Moreover, for each dollar of tax credit out of the federal fisc -- and into the hands of a non-profit -- a dollar could be contributed to the development of low-income housing. In our case H.O.M.E. could finance the entire 137 units of housing under option if H.O.M.E. could obtain the full value of their state-allocated tax credit. Then each dollar of tax credit would represent more than four dollars of low-income housing to the residents of New Haven.

Currently, the only refundable tax credit in the Internal Revenue Code is the Earned Income Credit. Congress' resistance to extending the concept of refundability to other tax preferences has typically been due to its fear of revenue loss and the potential for abuse, but the LIHTC's allocation limit of $1.25 per resident for each State effectively eliminates such concerns.

While refundability for non-profits is the most efficient solution, there are other alternatives before this Committee that might lower transaction costs and, thus allow more efficient utilization of the LIHTC. IF REFUNDABILITY IS IMPOSSIBLE, NON-PROFIT ORGANIZATIONS SHOULD BE ALLOWED TO TRANSFER LOW-INCOME HOUSING TAX CREDITS, ON A YEARLY BASIS, TO INDIVIDUAL INVESTORS. While this proposal would still contain some inefficiency due to investors' requirement of market returns on their investments, direct marketing by non-profits and the elimination of a 15-year required commitment by the investor and other restrictions could act to provide the non-profit with as much as 90 cents for each dollar of allocated LIHTC.

IV. Conclusion

Section 42 of the tax code was enacted because "Congress believed a more efficient mechanism for encouraging the production of low-income housing could be provided through the low-income rental housing tax credit."[4] Converting state allocated tax credits into low-income housing dollars, however, is anything but efficient due to transaction complexities created by the tax code. The net result is that even a non-profit organization with free legal and business counsel, such as H.O.M.E., can receive only about 50 cents for each dollar of Low-Income Housing Tax Credit allocated by the Connecticut Housing and Finance Authority.

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[4] Staff of the Joint Committee on Taxation, 1987, p. 152.

With absolutely no revenue effect, non-profit organizations could provide a dollar of low-income housing equity for every dollar of tax credit allocation by a provision allowing non-profit organizations, like H.O.M.E., to claim the tax credit on its tax return and receive, directly from the Treasury, an amount equal to the amount of the tax credit. This provision would maintain the protections of current law created by the application and review process administered by each state housing authority and would not involve any tax abuses, but would eliminate the syndicator's profit, the investors' required returns, and the various fees, costs, and expenses associated with the legal requirements necessary today to accomplish the transfer of tax benefits; instead the entire tax credit allocation would be used to finance the purchase of housing units. This, after all is the policy objective behind the credit. Refundability would directly achieve the tax and housing policy goals of the LIHTC; none of the other proposals currently under consideration would be as effective.

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